87-1513

No. 87-______

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

SECURITIES INDUSTRY ASSOCIATION,

Petitioner,

—v.—

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *et al*.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED

The court below affirmed an administrative authorization for bank affiliates to underwrite securities, including securities prohibited to banks themselves, and permitted that activity on a scale equalled only by the largest investment houses in the country. A bare majority of the Federal Reserve Board had granted the authority, despite Section 20 of the Glass-Steagall Act which prohibits bank affiliates from being "engaged principally" in underwriting "securities."

1. Did the court below err in rejecting a literal application of the term "securities" in Section 20 of the Glass-Steagall Act and excluding from that term those securities banks themselves may underwrite, even though this Court has held the term "securities" is to be applied literally and Section 20 contains no exception for any securities at all?

2. Did the court below err in construing the "engaged principally" restriction in Section 20 as authority for banks to affiliate again with entities that may rank among the largest underwriters of privately issued securities in the nation, even though Congress enacted Section 20 specifically to divorce commercial banks from their securities underwriting affiliates?

PARTIES TO THE PROCEEDING

In addition to the petitioner[1] and respondent listed in the caption, the following are also respondents in this action: Alan Greenspan, as Chairman of the Board of Governors of the Federal Reserve System,[2] Manuel H. Johnson, Martha R. Seger, Wayne D. Angell and H. Robert Heller as Members of the Board of Governors of the Federal Reserve System; and Bankers Trust New York Corporation, J.P. Morgan & Co., Inc., Citicorp, Chase Manhattan Corp., Manufacturers Hanover Corp., Chemical New York Corp. and Security Pacific Corp. as Intervenors-Respondents-Cross-Petitioners below.

1 Pursuant to Rule 28.1 of this Court, petitioner states as follows: the Securities Industry Association is a national trade association representing more than 500 securities brokers, dealers and underwriters who are responsible for over 90 percent of the securities brokerage and investment banking business in the United States.

2 Paul A. Volcker, Chairman Greenspan's predecessor as Chairman of the Board of Governors of the Federal Reserve System, was named as a respondent below. Chairman Greenspan, who succeeded Mr. Volcker while the case was pending below, has been substituted as a respondent pursuant to Rule 40.3 of this Court.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner Securities Industry Association ("SIA") respectfully requests that a Writ of Certiorari issue to review the opinion and judgment of the United States Court of Appeals for the Second Circuit entered in this proceeding on February 8, 1988.

OPINIONS BELOW

The initial Order of the Board of Governors of the Federal Reserve System ("Board") is reported at 73 Fed. Res. Bull. 473 (1987) (53a).[1] The subsequent Orders of the Board are reported at 73 Fed. Res. Bull. 607, 616, 618, 620 and 622 (1987) (146a, 151a, 156a, 160a, 166a and 171a). The opinion of the United States Court of Appeals for the Second Circuit granting a stay

1 Citations herein to material printed in the Appendix appear as "_____a."

of the Board's orders is unreported. The order of the court of appeals denying the SIA's Petition for Review (1a) is not yet reported. The further order of the Court of Appeals staying the issuance of its mandate pending SIA's filing of a petition for a writ of certiorari with this Court is unreported.

JURISDICTION

The Court of Appeals for the Second Circuit issued its opinion on February 8, 1988. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTE INVOLVED

This case involves the prohibitions of the Glass-Steagall Act.[2] Enacted in 1933, that Act was designed "to prohibit commercial banks . . . from going into the investment banking business" directly or indirectly.[3]

Two sections of the Act, Sections 16 and 21, govern the securities activities of banks directly. Section 16 flatly prohibits national banks from underwriting "any issue of securities or stock" and equally bars such banks from dealing for their own account in such instruments. 12 U.S.C. § 24 (Seventh). Section 16, however, contains a limited, express exemption for specified general obligations of the federal and state governments and certain government agencies (hereafter "government securities" or "eligible securities").[4] Section 21 of the Act also pro-

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2 What is generally referred to as the Glass-Steagall Act comprises four sections of the Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162, and is codified in sections of Title 12 of the United States Code, 12 U.S.C. §§ 24 (Seventh), 78, 377 and 378. Relevant provisions of the Act are set forth in Appendix H to this Petition.

3 *Investment Co. Inst.* v. *Camp*, 401 U.S. 617, 629 (1971) ("*ICI* I").

4 As used throughout this petition, the terms "government securities" or "eligible securities" mean those instruments expressly exempted from the underwriting and dealing prohibitions in Section 16 of the Glass-Steagall Act.

hibits member banks from being "engaged" in underwriting or dealing in "stocks, bonds, debentures, notes, or other securities," but expressly excludes from its prohibitions the government securities exempted from Section 16. 12 U.S.C. § 378(a)(1).

Two other sections of the Act, Sections 20 and 32, govern indirect securities activities of banks. Section 32 prohibits personnel interlocks between member banks of the Federal Reserve System and firms "primarily engaged" in underwriting "securities" without qualification. 12 U.S.C. § 78. This section does not contain any exemption from its prohibitions for government securities but does permit the Board by regulation to exempt certain "classes of cases" from the section's prohibitions. Section 20 of the Act, the section directly involved here, prohibits affiliation between member banks and entities "engaged principally" in underwriting and dealing in "securities," also without qualification. 12 U.S.C. § 377. Unlike the other sections of the Act, Section 20 contains neither an express exception for government securities nor any grant of exemptive authority to the Board.

Section 20 provides in relevant part:

> [N]o member bank [of the Federal Reserve System] shall be affiliated . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities.

STATEMENT OF THE CASE

At issue is the first decision since Congress passed the Glass-Steagall Act in 1933 that permits commercial banking organizations as principals to underwrite and deal in nongovernmental securities.[5]

5 As in the opinion of the Court below (22a), the phrase "underwrite and deal" will be used in this petition as a shorthand designation for all the activities prohibited by Section 20, *i.e.*, "flotation, underwriting, public sale or distribution" of securities.

A. The Administrative Proceedings

1. The Applications

Citicorp, the nation's largest banking organization and corporate parent of the nation's largest commercial bank, applied to the Board in 1985 for permission to underwrite as principal and deal for its own account in certain securities. It proposed to launch this new business through an affiliate, Citicorp Securities, Inc. ("CSI").[6] CSI would underwrite municipal revenue bonds, mortgage-related securities and consumer-receivable-related securities, together with government securities. (53a.) Citicorp contended that government securities should be considered beyond the scope of the term "securities" in Section 20, because they were exempted from Section 16 of that Act.[7] Proposing to limit CSI's underwriting of nongovernmental securities to ten percent of CSI's total underwriting activity, Citicorp argued that CSI therefore would not be "engaged principally" in underwriting "securities" in violation of Section 20. (64a.)

After Citicorp submitted its application, six of the nation's other largest money center banks submitted virtually identical applications, but adding commercial paper to the list of securities they proposed to underwrite.[8] Ultimately, thirteen of the largest banking organizations in the country requested the new

6 *See* 50 Fed. Reg. 20,847 (1985). Citicorp, a bank holding company, submitted its application pursuant to Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended, 12 U.S.C. § 1843(c)(8).

7 62a. In 1984, under the Bank Holding Company Act, the Board had authorized bank holding company affiliates to underwrite government securities. 12 C.F.R. § 225.25(b)(16).

8 *See* 50 Fed. Reg. 41,025 (1985) (J. P. Morgan & Co.); 51 Fed. Reg. 16,590 (1986) (Bankers Trust); 51 Fed. Reg. 42,300 (1986) (Chemical New York Corp.); 52 Fed. Reg. 1,380 (1986) (Chase Manhattan Corp.); 52 Fed. Reg. 6,218 (1986) (Manufacturers Hanover Corp.); and 52 Fed. Reg. 8,365 (1986) (Security Pacific Corp.). J. P. Morgan & Co. did not request permission to underwrite or deal in consumer-receivable-related securities. (54a n.2.) Citicorp subsequently submitted an application seeking to add commercial paper to CSI's permitted activities. 52 Fed. Reg. 13,317 (1986).

underwriting power under the novel theory proposed by Citicorp.[9]

2. Rulings of the Board Majority

After receiving and considering public comments on the initial three applications, the Board held a rare day-long public hearing. Following this hearing, by a narrow 3-2 vote (Chairman Volcker and Governor Angell dissenting), the Board conditionally approved the Citicorp, Morgan and Bankers Trust applications.[10] Two weeks later, by an identical vote, the Board approved the four remaining applications before it at that time.[11]

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9 In addition to the companies listed in note 8, *supra*, the following banking organizations have requested authority to underwrite and deal in these permitted securities: PNC Financial Corp., 52 Fed. Reg. 13,757 (1987); Marine Midland Corp., 52 Fed. Reg. 17,829 (1987); First Interstate Bancorp, 52 Fed. Reg. 32,606 (1987); Bank of New England Corp., 52 Fed. Reg. 43,799 (1987); First Bank System, Inc., 53 Fed. Reg. 2,782 (1987) and Bank of Boston Corp., application dated Jan. 28, 1988.

10 53a. The Board did not permit underwriting of consumer-receivable-related securities at the time, asking for further information concerning the market for these securities. (94a.) The Board, however, did subsequently approve each of the requests to underwrite and deal in such securities. 73 Fed. Res. Bull. 731 (1987).

11 The Board approved the subsequent applications of Chase Manhattan, Security Pacific, Manufacturers Hanover, and Chemical by Orders dated May 18, 1987, for the reasons set forth in its April 30, 1987 Order approving the Citicorp, Morgan and Bankers Trust applications. *See* 146a, 151a, 160a and 166a. At the same time, the Board approved a separate application of Citicorp for CSI to underwrite commercial paper. 156a.

The Board has continued to approve applications by various banking organizations to underwrite securities since this case was submitted to the court below. *See* PNC Financial Corp., 73 Fed. Res. Bull. 742 (1987); Marine Midland Corp., 73 Fed. Res. Bull. 738 (1987); First Interstate Bancorp, 73 Fed. Res. Bull. 928 (1987); Bank of New England Corp., 74 Fed. Res. Bull. 133 (1988). The SIA has petitioned the court below for review of each of those Orders; those petitions have been withdrawn from active consideration pending final disposition of this case.

The Board majority recognized the "precedent-setting" nature of the applications and observed that its ruling addressed "fundamental questions concerning the scope of the Glass-Steagall Act's restrictions." (58a, 57a.) The majority also acknowledged that

> on its face, section 20 draws no distinction between eligible [*i.e.*, government] and ineligible securities, as is the case under other sections of the Glass-Steagall Act. The section simply contains a prohibition on a member bank's affiliation with any corporation engaged principally in underwriting "stocks, bonds, debentures, notes, or other securities."

(67a.) The majority, however, ruled the term "securities" in Section 20 did not encompass all securities. Instead, the majority concluded that the express exemption in Section 16 for banks to underwrite specified government securities should "*a fortiori*" apply to bank affiliates, notwithstanding the absence of any similar exception for affiliates in Section 20. (67a-68a.) To conclude otherwise, the majority reasoned, "would be out of harmony with the central purpose of the Act." (70a.)

Based upon its "central purpose" analysis, the majority determined a bank could create an affiliate that would engage *exclusively* in underwriting securities, so long as the underwriting of securities not authorized for banks themselves does not amount to a "substantial" part of the affiliate's overall business. (76a.) The majority found the permitted level of the latter activities to constitute (a) "a range of between 5 and 10 percent" of an affiliate's total revenues and (b) up to ten percent of the market for each type of nongovernmental security. (83a.) In those circumstances, the majority ruled, the affiliate would not violate the Section 20 prohibition against affiliates being "engaged principally" in underwriting securities. It made no difference to the majority that an affiliate would regularly underwrite and deal in "ineligible" securities or that its business in that

respect could rank it among the country's largest investment houses in a given market.[12]

The majority conceded that, at the volume level authorized, the new underwriting and dealing activities raised various of the "fundamental hazards at which the Glass-Steagall Act was aimed." (115a.) The majority therefore constructed "an extensive framework of prudential limitations" (134a) to govern the proposed activities and concluded that the applications "comply with existing law under the framework established." (127a.)

3. The Board Dissents

Chairman Volcker and Governor Angell dissented. They found the majority's result directly inconsistent with the language and policy of the Glass-Steagall Act. In their view:

> the plain words of the statute, read together with earlier Supreme Court and circuit court opinions, as we understand them, indicate that government securities are indeed "securities" within the meaning of section 20. Consequently, it appears to us that the applications approved today, as a matter of law, involve affiliations of member banks with corporations that are in fact not only "principally engaged" in dealing and underwriting in securities, but in fact would be wholly engaged in such activities . . . .

(136a-137a.) The dissenters observed that the majority ruling would make legally possible the "affiliations of banks with some of the principal underwriting firms or investment houses of the country," thereby violating the "intent of Congress" as well as the statutory language. (137a.)

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12 83a-85a. Because of the Applicant's lack of experience in underwriting and trading the nongovernmental securities, the Board initially limited the affiliates to the "5 percent end of the permissible range of activity," but committed to "review this determination, within one year, after Applicants have gained some experience in operating the proposed underwriting subsidiaries, to assess whether somewhat higher levels of activity up to 10 percent may be permissible." (84a-85a).

B. The Opinion Below

The SIA immediately petitioned the United States Court of Appeals for the Second Circuit to review the Board's Order. At the same time, the SIA asked the court to stay the effective date of the Board's Order pending judicial review. The court granted the requested stay, and subsequently expanded it to stay the later-issued Board Orders as well.[13] Seven banks intervened and filed cross-petitions for review of the Board's Orders. The court of appeals denied SIA's petition for review on February 8, 1988. (1a.)

The court acknowledged in its decision that the Board's rulings would permit commercial banks to expand into underwriting nongovernmental securities and to that extent would "dismantle the wall of separation installed between [commercial and investment banks] by the Glass-Steagall Act." (5a.) The court also recognized that "on the surface § 20 would appear to refer" to all kinds of "securities," including government securities. (13a.) The court further noted that the Board itself had held the unqualified term "securities" to encompass government securities in a long-standing Glass-Steagall interpretation equally applicable to Section 20. (15a-16a.) And, citing this Court's teaching, the court confirmed that unambiguous statutory language "must be given effect by the agency and the courts." (13a.)

The court, however, determined not to give effect to the plain meaning of the term "securities" in Section 20. The court reasoned that the Act contains three different references to "securities" and that Congress had amended Section 21 of the Act to clarify that its prohibition of banks' underwriting "securities" did not apply to government securities. (14a.) Accordingly, "with some confidence," the court of appeals concluded the term "securities" in Section 20 was "ambiguous." (*Id.*) In doing so, the court did not discuss this Court's earlier admonition that the unqualified term "securities" in the Glass-Steagall Act

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13 *Securities Industry Ass'n* v. *Board of Governors*, No. 87-4041 (2d Cir. Order dated May 19, 1987).

is to be applied as it is written. *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 137 (1984).

Rejecting full deference to the Board's views because of the Board's failure to discuss its own earlier ruling concerning the breadth of the term "securities," the court undertook its own review of the Act's legislative history. (17a.) The court concluded Section 20 represented a "compromise" between Senators who wanted to legislate securities affiliates out of existence and those who wanted merely to subject the affiliates to administrative regulation. (25a-27a.) In the court's view, it could be "plausibly urged" that Congress did not expressly exempt government securities from Section 20, because Congress understood those instruments were outside its concern, which, the court found, "was primarily with bank affiliate activities in bank-ineligible securities." (30a.) The court held that reading Section 20 to exempt government securities was "essential" to effectuating "Congress' purpose" in enacting that provision. (17a.)

The court below also concluded that the Board reasonably had construed the "engaged principally" standard in Section 20 to mean any "substantial" nongovernmental securities activity. (46a.) The court relied upon *Board of Governors* v. *Agnew*, 329 U.S. 441 (1947), in which this Court held that the term "primarily engaged" in Section 32 of the Act meant "substantially." The court below found the term "engaged principally" in Section 20 synonymous with "primarily engaged" in Section 32. (41a.) The court also agreed with the Board that "substantial" meant no more than ten percent of an affiliate's nongovernmental securities activities. (48a.) Granting the banks' cross-petitions to a limited extent, however, the court rejected the Board's limitation of each affiliate's market share for a particular nongovernmental security. (49a.)

After the court of appeals filed its opinion, the SIA requested the court to defer issuance of its mandate and thereby to continue in effect its stay of the Board's rulings. On February 29, 1988, the court below deferred issuance of its mandate for 15 days to permit the SIA to file its petition with this Court. The

timely filing of this petition has continued that stay until final disposition by the Court. *See* Fed. R. App. P. 41(b).

REASONS FOR GRANTING THE WRIT

I.

THE OPINION BELOW RAISES IMPORTANT ISSUES OF NATIONAL SIGNIFICANCE

This case is of enormous significance to the financial markets throughout the country. By permitting bank affiliates, as principals, to underwrite nongovernmental securities the decision below radically alters the structure of the nation's financial services industry.

The court of appeals underscored the importance of the issues here by continuing its stay of the Board's rulings, even after its affirmance, in order to maintain the *status quo* pending review by this Court. As the court below had put it, the banks' applications involve an "issue of first impression," and the Board's approvals will significantly "dismantle the wall of separation" Congress built between commercial and investment banking through the Glass-Steagall Act. (5a.)

The Board majority also had acknowledged the status-shattering impact of its actions: its rulings concerned applications that were "precedent-setting" (58a); raised "fundamental questions concerning the scope of the Glass-Steagall Act's restrictions" (57a); and would permit "the first major entry of banking organizations into the field of underwriting and dealing." (134a.) More specifically, as then Chairman Volcker and Governor Angell emphasized in dissent, the majority rulings would permit "affiliations of banks with some of the principal underwriting firms or investment houses of the country" directly contrary, in their view, to "the intent of Congress in passing the Glass-Steagall Act." (137a.)

The Court previously has determined to review issues arising out of SIA challenges to regulatory interpretations affecting the

boundaries between commercial and investment banking "[b]ecause of the importance of the issue for the Nation's financial markets." *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 137, 142 (1984) ("*SIA* I"); *see Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 207 (1984) ("*SIA* II"); *Clarke* v. *Securities Industry Ass'n*, 107 S. Ct. 750 (1987). Of the SIA cases to have reached the Court, however, none has involved banking organizations, *as principals*, underwriting and dealing in securities—activities unquestionably at the crux of the Glass-Steagall prohibitions. No issue in any SIA case has had greater national importance.

1. The rulings represent a fundamental alteration of the Glass-Steagall Act, the basic statutory underpinning for the structure of the entire financial services industry in this country. Passed in June 1933, the Act followed in the wake of the Great Depression and the near-total collapse of the American financial system, as thousands of bank failures occurred across the country.[14] Congress intended the Act to "protect bank depositors from any repetition of [those] widespread bank closings." *Board of Governors* v. *Investment Co. Inst.*, 450 U.S. 46, 61 (1981) ("*ICI* II"). It did so primarily by restricting severely the ability of banks and their affiliates to underwrite and deal in securities.

The Act "responded to the opinion, widely expressed at the time, that much of the financial difficulty experienced by banks could be traced to their involvement in investment-banking activities both directly and through security affiliates." *SIA* I, 468 U.S. at 144. By the end of the 1920s, national banks and their affiliates had expanded their securities activities to the point they "had become the dominant force in the investment banking field."[15] As Senator Glass put it during the Senate debates, 77 Cong. Rec. 3725 (1933):

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14 Willis & Chapman, *The Banking Situation* 7, 10 (1934); Klebaner, *Commercial Banking in the United States: A History* 131-35 (1974).

15 Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 Banking L.J. 483, 495-496 (1971).

> [I]nvestment affiliates . . . were the largest contributors, next to the gambling on the stock exchange, to the disaster which was precipitated upon the country in 1929.

The Act thus was a "prophylactic measure directed against conditions that the experience of the 1920's showed to be great potentials for abuse." *ICI* I, 401 U.S. at 639. Rejecting mere regulation of banks' securities activities, Congress adopted "a broad structural approach" in the statute that operated "[t]hrough flat prohibitions" to separate commercial banks from investment banking "as completely as possible." *SIA* I, 468 U.S. at 147.

Section 20 of the Glass-Steagall Act, the provision at issue in this case, spoke directly to bank affiliation with securities underwriters. It provides that no member bank of the Federal Reserve System may affiliate with any entity "engaged principally" in underwriting or dealing in "stocks, bonds, debentures, notes or other securities."[16] The Section contains no exception for *any* type of securities.

Through Section 20, Congress required banks to divest themselves of affiliates involved in underwriting by no later than June 16, 1934. This "absolute divorce of all commercial and investment banking activities" caused one of the most sweeping corporate reorganizations ever experienced in our country,[17] and "revolutionized the structure of the investment banking community."[18] The Act was a "drastic step." *ICI* I, 401 U.S. at 629. As the Court has explained:

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16 12 U.S.C. § 377. Section 20 applies in this case because the proposed securities entities would be affiliated through common ownership with member banks of the Federal Reserve System. If violated, Section 20 bars the affiliation. *See SIA* II, 468 U.S. at 216.

17 Perkins, *supra*, at 525; Carosso, *Investment Banking in America* 369, 371-74 (1970). *See, e.g.*, *New York Times*, June 1, 1934 at 1; *New York Times*, June 8, 1934 at 31; *New York Times*, June 16, 1934 at 21.

18 Carosso, *supra*, at 368.

> The Glass-Steagall Act confirmed that national banks could not engage in investment banking directly, and in addition made affiliation with an organization so engaged illegal. *One effect of the Act was to abolish the security affiliates of commercial banks.*

Id. (emphasis supplied).

The prohibitions of the Glass-Steagall Act have remained firmly in place for over half a century. Those prohibitions are no less significant to the financial markets today than when Congress enacted them in 1933—an importance dramatically underscored by the financial chaos of October 19, 1987. The current structure of the financial services industry, insofar as the issues here are concerned, has also existed throughout that half century. During that period, no bank covered by the Act even sought permission to underwrite nongovernmental securities through affiliates. Now, a bare majority of the Board—without any change at all in the statutory mandate—has permitted just that.

2. The effect of the decision below is all but to nullify the flat prohibitions of the Glass-Steagall Act. It will permit virtually every major money-center bank in the United States immediately to establish affiliates to conduct underwriting and dealing activities that, by congressional mandate as universally understood and applied for over 50 years, have been barred to them. The Board has already approved the applications of thirteen of the largest banking corporations in the country, several of which were the *same* entities whose activities were the focus of congressional debate in 1933. Still further applications continue to be filed by other banking organizations.

Even under the revenue and market share limits initially adopted by the Board, bank affiliates would be able to underwrite and deal in the permitted "ineligible" securities to an extent greater than all but a handful of the largest investment

banks in the country.[19] In combination, the affiliates may control the majority of the market for such securities and again become the dominant force in those markets—just the sort of circumstance that led Congress to enact the Section 20 prohibition in the first place.

The court of appeals went further still, striking down the Board's market share limitation on affiliates' activities. (48a-50a.) As a result, bank affiliates may underwrite and deal in essentially unlimited amounts of nongovernmental securities, because, as the Board itself recognized, the remaining gross revenue "limitation" may easily be manipulated through "the deliberate creation of a large base of eligible activity." (73a n.29.) Banks can, and inevitably will, shift unregulated activities into securities affiliates in order to inflate the gross revenues against which their nongovernmental underwriting and dealing activities would be measured.[20] That, in turn, would permit banking organizations to establish underwriting and dealing operations

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19 For example, under the Board's rulings *each* bank affiliate may underwrite approximately $4.35 billion of municipal revenue bonds—an amount greater than that currently underwritten by all but the six very largest investment firms in this market. (Statement of Jeffrey M. Schaefer, dated January 30, 1987, Joint Appendix ("J.A.") at 216-219, *Securities Industry Ass'n* v. *Board of Governors*, No. 87-4041 (2d Cir. Feb. 8, 1988)). *Each* bank affiliate may also underwrite approximately $2.86 billion of mortgage-related securities—an amount larger than all but the five largest investment firms in this market. (*Id.* at 5-8, J.A. 219-22.) And, *each* bank affiliate may underwrite approximately $50 billion of commercial paper this year, a market for which share data are unavailable. (*Id.* at 9, J.A. 223.)

20 As a leading bank trade publication reported shortly after the opinion below was filed:

> Big banks expect to get around the 5% [gross revenue] limit by padding the base against which their revenues are measured. They will stuff their new activities into existing broker-dealer subsidiaries or into new entities. "We'll just increase revenue in the permissible [*i.e.*, government] securities," said an attorney at Citicorp.

Horowitz, "Court Decision Changes the Landscape," *American Banker*, Feb. 10, 1988 at 15.

in nongovernmental securities rivaling in size those even now matched only by a handful of the country's largest securities houses.[21] Alternatively, banks holding companies could simply absorb major securities firms.[22]

The rationale of the court below would in no way be limited by the Act to underwriting only the types of securities involved in this case. A level of underwriting permitted by Section 20 is permitted for *all* securities—whether speculative stocks or junk bonds. Section 20 makes no distinction among the "securities" it covers. A Congress that sought to separate commercial from investment banking "as completely as possible," *SIA* I, 468 U.S. at 147, could not conceivably have envisioned, let alone intended, anything like the result permitted below.

3. The decision below also raises basic questions concerning the role of administrative agencies in setting national policy. Congress has intensely debated over the past several terms, including the present term, the policy considerations involved in extending new securities authority to bank holding companies. Congress has repeatedly refused to weaken the flat prohibitions

21 For example, PaineWebber in 1986 derived $695 million in revenue from underwriting and dealing activities in *all* securities. Assuming no more than half of these revenues were from bank eligible activities, Paine Webber's revenue from ineligible activity was approximately $350 million. Citicorp, which in 1986 had revenues of $23.5 billion, could create a securities affiliate underwriting and dealing in ineligible securities on a scale equal to PaineWebber merely by transferring to a separate subsidiary existing activities generating only 15% of its current gross revenues. *See Moody's Banking and Finance Manual* (1987) at 5478 (PaineWebber Group Inc.), 144 (Citicorp).

22 Underwriting and dealing activities (*including* "eligible" as well as other securities), for instance, accounted in 1986 for less than 21% of total revenues at Merrill Lynch & Co., and 18% at E.F. Hutton Group, Inc. Taking into account only the revenues derived from "ineligible" securities activities, even firms of this size could have been acquired by banks, with Glass-Steagall impunity, under the rationale of the holding below. *See* Merrill Lynch & Co., *1986 Annual Report* at 53; E.F. Hutton Group, Inc., *1986 Annual Report* at F-18.

mandated by the Glass-Steagall Act[23] and has expressly confirmed that bank regulators have *no* authority to alter the Act through administrative rulemaking.[24] Congress also reacted sharply to the Board proceedings at issue in this case,[25] with its level of frustration reaching the point that in August 1987, Congress enacted a statutory moratorium lasting until March 1, 1988 upon all Board approvals of the sort at issue. *See* Competitive Equality Banking Act of 1987, § 201, Pub. L. No. 100-86, 101 Stat. 552.

National policy, of course, is to be set by legislative deliberation and not by administrative edict. Any shift in the statutory boundaries between the securities and banking industries requires a fundamental policy decision that can be made only by Congress, because only it can weigh all of the policy considerations involved. As the Board itself recognized in commenting on an earlier application to establish an underwriting affiliate:

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23 For example, in 1984 the House refused even to consider legislation the Senate had passed to authorize bank affiliates to underwrite three of the specific securities the majority's rulings now seek to authorize administratively. S. 2851, 98th Cong., 2d Sess. (1984).

24 In 1980, Congress authorized the Comptroller of the Currency to issue rules and regulations but "expressly continued to withhold from the Comptroller the authority to issue regulations concerning 'securities activities of National Banks under the Act commonly known as the "Glass-Steagall Act." ' " *SIA* I, 468 U.S. at 154 (quoting Depository Institutions Deregulation and Monetary Control Act of 1980, § 708, 94 Stat. 188, 12 U.S.C. § 93a).

25 The Chairman of the Senate Banking Committee had written to the Board before the February 3 hearing that "approval of the applications would contravene the intent of [the Act]" and "would involve a major reversal of policy that can only be effected by the Congress." 133 Cong. Rec. S.4022-23 (daily ed. Mar. 27, 1987). And, after the Board's initial ruling was issued, the Chairman of the House Banking Committee stated that the majority "has misunderstood and misinterpreted the law and congressional intent." *See* Campbell, "SIA Asks Appellate Court to Overrule Fed on Bank Securities Underwriting," *The Bond Buyer*, May 4, 1987 at 3.

> Congress is the appropriate forum for resolution of the public policy considerations involved in proposals . . . that would dramatically alter the framework established by Congress in the Glass-Steagall Act.[26]

By affirming the Board, the court effectively sanctioned just such an administrative effort to "dramatically alter" Congress' Glass-Steagall mandate without any legislative sanction whatever.

In sum, this case involves fundamental issues of overriding national significance. For this reason alone, review by the Court is warranted.

II.

THE OPINION BELOW CONFLICTS WITH PRIOR DECISIONS OF THIS COURT AND RAISES SUBSTANTIAL QUESTIONS OF FEDERAL LAW THAT SHOULD BE DECIDED BY THE COURT

The opinion below contravenes repeated admonitions of the Court concerning the Glass-Steagall Act—its plain language, congressional purpose, statutory structure and administrative interpretation.

1. The Court has instructed repeatedly that the prohibitory terms of the Glass-Steagall Act are to be applied "as they were written."[27] A fundamental issue in this case is the scope of the phrase "stocks, bonds, debentures, notes, or other securities" contained in Section 20 of the Act. The court below ruled that this language, even though unqualified in the Act, should be qualified to exempt government securities. (37a.) This Court, however, has already all but decided that the decision below was wrong.

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26 *Withdrawal of Citicorp Application*, 71 Fed. Res. Bull. 225 (1985).

27 *ICI* I, 401 U.S. at 639; *accord ICI* II, 450 U.S. at 65 (confirming that the Court "relied squarely on the literal language" of the Act).

In *SIA* I, the Court reviewed a ruling in which the Board had exempted certain low-risk securities (commercial paper) from the phrase, "stocks, bonds, debentures, notes, or other securities," contained in the underwriting prohibition of Section 21 of the Act. The Court agreed with the SIA that "the plain language of the Act makes untenable the Board's conclusion that commercial paper is not a 'security' within the meaning of the Act." 468 U.S. at 149. Nullifying the Board's ruling, the Court confirmed that " 'there is nothing in the phrasing of . . . § 21 that suggests a narrow reading of the word "securities" ' " (quoting *ICI* I, 401 U.S. at 635). The Court flatly rejected the Board's "departure from the literal meaning of the Act" and its "attempt to narrow the ordinary meaning of the statutory language." 468 U.S. at 152-53.

Section 20 of the Act, involved here, is equally clear. In language *identical* to that construed by the Court in *SIA* I, Section 20 absolutely bars bank affiliates from engaging principally in underwriting "stocks, bonds, debentures, notes, or other securities." The plain statutory language thus covers all types of "securities" without qualification. And, there is no dispute the instruments at issue (government securities) fall within the literal meaning of that phrase; the court below and the Board majority conceded just that.[28] The result, therefore, should be just as clear. As the dissenting Board members stated, "the plain words of the statute, read together with earlier Supreme Court and circuit court opinions . . . indicate that government securities are indeed 'securities' within the meaning of Section 20." (136a.)

Even so, the court below affirmed the Board majority's refusal to apply the Act's terms as they were written. Instead, the court of appeals "with some confidence" inferred ambiguity in a phrase this Court has already ruled contains none. (14a.) The court then "narrow[ed]" the statutory language of Section 20 and "depart[ed] from its literal meaning." In doing so, the

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28 *See* 67a ("on its face, Section 20 draws no distinction between eligible and ineligible securities"); 13a ("on the surface § 20 would appear to refer to both kinds of securities").

court below did not even cite, let alone attempt to distinguish, this Court's contrary instruction in *SIA* I. The court simply contravened the Court's admonition and thereby Congress' statutory mandate.

2. This Court also has stated that the Board is not to substitute its view of the "plain purpose" of a statute for the "plain language" enacted by Congress. The Board majority, affirmed below, nevertheless supplanted the plain language of Section 20 with its view of the "central purpose" of the Act and again violated what the Court has told the Board.

In *Board of Governors* v. *Dimension Financial Corp.*, 474 U.S. 361 (1986), the Board had relied upon its view of the "plain purpose" of the Bank Holding Company Act, instead of the plain language of the statute, to conclude that certain entities came within that Act's definition of a "bank." Voiding the Board's "invocation of the 'plain purpose' of legislation at the expense of the terms of the statute," the Court stated:

> The statute may be imperfect, but the Board has no power to correct flaws that it perceives in the statute it is empowered to administer.

Id. at 374. The Court also underscored the obligation of the Board as well as the courts to enforce statutory language:

> If the statute is clear and unambiguous "that is the end of the matter, for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[29]

As in *Dimension*, the terms of the governing statute here are "clear and unambiguous." All parties agree the plain language of Section 20 prohibits banks from affiliating with entities engaged principally in marketing "securities" of *any* kind. The affiliates sanctioned by the majority will engage exclusively in marketing securities of various kinds. Accordingly, as the

29 *Id.* at 368 (quoting *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984)).

Court put it in *Dimension*, that *should* have been "the end of the matter."

Yet, the court below read into Section 20 an exception for government securities, not because the plain language required that result, but because in the court's opinion that reading was "essential" to effectuate its view of "Congress' purpose in enacting § 20." (17a.) Substituting its own view of the Act's "purpose" for the statutory language used by Congress, the court below, as had the majority of the Board, violated the instructions of this Court.

Ironically, the court's rationale actually undermines the congressional "purpose" it purports to support. According to the court below, Congress' purpose in passing the Act was "to attack . . . bank involvement in speculative securities, that is, bank-ineligible securities." (31a-32a.) The court confirmed that the bank affiliates targeted by Congress in 1933 had been established initially to assume the role of banks in underwriting government securities but then used that base of activity to expand into the distribution of speculative securities as well. (31a.) By exempting government securities from Section 20, however, the court of appeals permitted bank affiliates again to establish a huge revenue base derived from underwriting those securities that in turn will again be used as a springboard for underwriting massive amounts of "bank-ineligible securities."[30] Thus, not only did the court below incorrectly extol its view of Congress' "plain purpose" over Congress' own "plain language," but in doing so, the court also fostered just the activities it found Congress had intended to "attack."

3. This Court has repeatedly stated that, " 'where Congress includes particular language in one section of a statute but

30 As the Board explained (61a):

> Because of the operation of the net capital rules established by the Securities and Exchange Commission for broker-dealers, as a practical matter it is not feasible for bank affiliates to underwrite and deal in ineligible securities, other than commercial paper, within the confines of section 20 unless the subsidiary in which this activity takes place is engaged principally in underwriting and dealing in eligible securities—essentially U.S. government securities.

omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.' " *Russello* v. *United States*, 464 U.S. 16, 23 (1983) (citations omitted). Specifically as to Glass-Steagall, the Court has taught that "the structure of the Act reveals a congressional intent to treat banks *separately* from their affiliates," *ICI* II, 450 U.S. at 59 n.24 (emphasis supplied), and has instructed that "[t]here is no basis for assuming that the dissimilar phrases found in §§ 16 and 20 [of the Glass-Steagall Act] are coterminous. . . . § 16 applies only to banks, not to bank holding companies. . . ." *SIA* II, 468 U.S. at 219 n.20.

Once again, the court below avoided what this Court has said. Congress included an express exemption for government securities in Section 16 and in 1935 also incorporated that exemption into Section 21 of the Act.[31] Congress, however, created *no* such exemption, either initially or by amendment, to the prohibitions of Section 20, which continue to reach "securities" underwriting without exception. By reading Section 20 to encompass the exemption Congress has omitted from that section but included in Sections 16 and 21, the court of appeals obliterated the differences built by Congress into the Glass-Steagall structure as well as this Court's direction concerning its proper application.

4. The Board itself for over 50 years has interpreted the Glass-Steagall term "securities" to include government securities, in a regulation this Court has held applicable to Section 20. The Board issued that interpretation under Section 32 of the Act, which bars personnel interlocks between member banks and entities primarily engaged in underwriting "securities." As in Section 20, the term "securities" in Section 32 is unqualified. Beginning in July 1934, the Board held that "[S]ection 32 *does not contain any exception* based upon the kind of securities underwritten or dealt in," in marked contrast to Section 16 of the Act which, as the Board went on to explain, "specifically ex-

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31 Banking Act of 1935, Pub. L. No. 74-305, Ch. 614, tit. III, § 303(a), 49 Stat. 684, 707, codified at 12 U.S.C. § 378(a)(1).

cepts certain municipal and other obligations" from its prohibitions. 20 Fed. Res. Bull. 485 (1934) (emphasis supplied).

Acting pursuant to express authority in Section 32 to exempt interlocks "not incompatible with the public interest," the Board then permitted correspondent relationships between member banks and dealers in certain government securities. *Id.* The Board has carried forward this interpretation in its Regulation R, which, even now over five decades later, *exempts* interlocks with entities engaged in underwriting "only" government securities—confirming that such entities otherwise are *included* within the flat Section 32 prohibition.[32]

This Court has said specifically that the Board's "long-accepted interpretation" in its Regulation R "should apply as well to § 20." *SIA* II, 468 U.S. at 219. Both sections "contain identical language, were enacted for similar purposes, and are part of the same statute." *Id.* And, under that "long-accepted interpretation," government securities are "securities" within the language of Section 32.

Despite this Court's teaching and the obvious relevance of the Board's Regulation R to the issues here, the Board majority did not say one word about it in reaching exactly the opposite conclusion as to the scope of the "securities" covered by Section 20. The court of appeals agreed the majority ruling was patently "defective" for not having done so (15a-16a) and yet committed the same error itself by making no attempt to reconcile its own rationale with the contemporaneous understanding of those who knew best what Congress intended.[33]

Section 32 is unique among the Glass-Steagall provisions in granting the Board any exemptive authority at all. Congress expressly granted the Board administrative authority in Section 32 to exempt personnel overlaps from its interlock prohibitions. In stark contrast, Congress granted the Board *no* exemptive authority in Section 20 to permit affiliations otherwise barred by

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32 12 C.F.R. § 218.2; *see* 16a.

33 *See Morton* v. *Ruiz*, 415 U.S. 199, 237 (1974); *Espinoza* v. *Farah Mfg. Co.*, 414 U.S. 86, 94 (1973).

its plain language. In effect, the court below permitted the Board administratively to assume just the sort of exemptive authority under Section 20 that Congress has withheld.

5. The court of appeals' interpretation of the phrase "engaged principally" in Section 20 equally contravened congressional intent and reflected a "regulatory approach" at odds with this Court's decisions under the Act. By prohibiting bank affiliates under Section 20 from being "engaged principally" in underwriting securities, Congress intended to prohibit banks from indirectly "carrying on . . . the investment security business" through affiliation with entities regularly involved in that business, on a "day to day and week to week" basis.[34] As the Court has confirmed, one effect of the Act was "to abolish the security affiliates of commercial banks." *ICI* I, 401 U.S. at 629. Congress wrote Section 20 to speak "in the language of prohibition, not authorization."[35]

The court below nevertheless interpreted "engaged principally" by a quantitative measure alone that would allow bank affiliates to derive as much as ten percent of their revenues from underwriting privately issued securities—thereby permitting bank affiliates once again regularly to carry on that business and to do so at levels matched only by the largest investment firms in the country. By "authoriz[ing]" rather than "prohibit[ing]" the reemergence of bank security affiliates on a scale unequalled since 1929, the court of appeals simply reversed Congress' Glass-Steagall intent.

The Board itself confirmed that, at the volume level now sanctioned under Section 20, the proposed underwriting activities would cause a number of the "fundamental hazards" (115a) that were of major concern to the Glass-Steagall Congress. Yet, instead of reducing that volume level to a point at which the potential for those hazards would be *de minimis*, the Board constructed "an extensive framework of prudential limi-

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34 75 Cong. Rec. 9905 (1932) (remarks of Sen. Walcott); *see also* 75 Cong. Rec. 9911 (1932) (remarks of Sen. Bulkley).

35 *Investment Co. Institute* v. *FDIC*, 815 F.2d 1540, 1548 (D.C. Cir.), *cert. denied*, 108 S. Ct. 143 (1987).

tations," (134a) covering everything from lending arrangements to office space (128a-134a). The Board then ruled that, "under the framework established," the activities would "comply with existing law." (127a.)

In affirming the Board, the court below held the "necessity of 'regulation' in carrying out Glass-Steagall's 'prohibitions' " did not violate the Act. (45a.) To the contrary, this Court has left no doubt that administrative guidelines (here, "framework") are *not* to substitute for the Glass-Steagall prohibitions. *SIA* I, 468 U.S. at 153. As the Court bluntly stated, "Congress rejected a regulatory approach when it drafted the statute, and it has adhered to that rejection ever since." *Id.* By ruling as it did, the court of appeals allowed the Board again "effectively [to] convert a portion of the Act's broad prohibition into a system of administrative regulation" (*id.*), and thereby yet again to contravene this Court's direction as well as Congress' purpose "when it drafted the statute" and "ever since."

CONCLUSION

The decision below raises fundamental issues of federal law that have overriding significance for the entire financial services industry. It also conflicts with the Court's prior decisions concerning the scope and application of the Glass-Steagall Act. A writ of *certiorari* should issue to review this decision.

Dated: March 10, 1988

Respectfully submitted,

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No. 87-1579

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

SECURITIES INDUSTRY ASSOCIATION,

Petitioner,

—v.—

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *et al.*,

Respondents.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 1488, 1489, 1490, 1491, 1492,
1493, 1494—August Term 1986

(Argued June 23, 1987 Decided February 8, 1988)

Docket Nos. 87-4041, 87-4055, 87-4057, 87-4059,
87-4061, 87-4063, 87-4067, 87-4069, 87-4071, 87-4073,
87-4075, 87-4077, 87-4079, 87-4085

SECURITIES INDUSTRY ASSOCIATION,

Petitioner-Cross-Respondent,

—v.—

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, PAUL A. VOLCKER, as Chairman of the Board of Governors of the Federal Reserve System, MANUEL H. JOHNSON, WAYNE D. ANGELL, ROBERT H. HELLER, and MARTHA R. SEGER, as members of the Board of Governors of the Federal Reserve System,

Respondents,

BANKERS TRUST NEW YORK CORPORATION, J.P. MORGAN & CO. INCORPORATED, and CITICORP and THE CHASE MANHATTAN CORPORATION, MANUFACTURERS HANOVER CORPORATION, and CHEMICAL NEW YORK CORP., SECURITY PACIFIC CORPORATION,

Intervenors-Respondents Cross-Petitioners.

B e f o r e :

CARDAMONE, PIERCE and WINTER,
Circuit Judges.

The Securities Industry Association petitions for review of six orders of the Board of Governors of the Federal Reserve System. The Board found that bank holding company subsidiaries already engaged entirely in underwriting and dealing in federal, state, and local government securities could underwrite and deal in, to a limited extent, municipal revenue bonds, mortgage related securities, and commercial paper without contravening § 20 of the Glass-Steagall Act. Bankers Trust New York Corp., J.P. Morgan & Co., Inc., Citicorp, The Chase Manhattan Corp., Manufacturers Hanover Corp., Chemical New York Corp. and Security Pacific Corp. cross-petition for review of the Board's limitations on the securities activities of their subsidiaries.

Petitions for review denied.

Cross-petition for review denied in part and granted in part.

JAMES B. WEIDNER, New York, New York (David A. Schulz, Mark Holland, Peter Kimm, Jr., Roger & Wells, New York, New York; William J. Fitzpatrick, New York, New York; Donald J. Crawford, Washington, D.C., of counsel), *for Petitioner-Cross-Respondent Securities Industry Association.*

MICHAEL S. HELFER, Washington, D.C. (Christopher Lipsett, Thomas P. Olson, Wilmer, Cutler & Pickering, Washington, D.C., of counsel), *Pro Hac Vice for Intervenor-Respondent Cross-Petitioner Citibank.*

LEWIS B. KADEN, New York, New York (Lowell Gordon Harriss, D. Scott Wise, Davis Polk & Wardwell, New York, New York, of counsel), *for Intervenor-Respondent Cross-Petitioner J.P. Morgan & Co. Incorporated.*

RICHARD M. ASHTON, Washington, D.C., (Richard K. Willard, Assistant Attorney General, U.S. Department of Justice, Michael Bradfield, General Counsel, Kay E. Bondehagen, Douglas B. Jordan, Washington, D.C.; Robert M. Kimmitt, Department of the Treasury; Richard V. Fitzgerald, Office of the Comptroller of the Currency, Washington, D.C., of counsel), *for Respondents Board of Governors of the Federal Reserve System, et al.*

DAVIS POLK & WARDWELL, New York, New York, attorneys for J.P. Morgan & Co., Incorporated; White & Case, New York, New York, attorneys for Bankers Trust New York Corporation; Shearman & Sterling, New York, New York and Wilmer, Cutler & Pickering, Washington, D.C., attorneys for Citicorp; Cravath, Swaine & Moore, New York, New York,

attorneys for Chemical New York Corporation; Milbank, Tweed, Hadley & McCloy, New York, New York, attorneys for The Chase Manhattan Corporation; Simpson Thacher & Bartlett, New York, New York, attorneys for Manufacturers Hanover Corporation; O'Melveny & Myers, New York, New York, attorneys for Security Pacific Corporation; all of counsel), *filed a brief on behalf of Intervenors-Respondents Cross-Petitioners.*

MARTIN GLENN, O'Melveny & Myers, New York, New York (Russell A. Freeman, Dan C. Aardal, Security Pacific Corporation, Los Angeles, California; Edward J. McAniff, Michael J. Fairclough, O'Melveny & Myers, Los Angeles, California; William T. Coleman, Jr., John H. Beisner, Jacob M. Lewis, James P. Nehf, O'Melveny & Myers, Washington, D.C., of counsel), *filed a brief on behalf of Intervenor-Respondent, Cross-Petitioner Security Pacific Corporation.*

DAVID M. MILES, Washington, D.C. (Harvey L. Pitt, Henry A. Hubschman, Fried, Frank, Harris, Shriver & Jacobson, Washington, D.C.; Matthew P. Fink, Senior Vice President and General Counsel, Sarah O'Neil, Associate General Counsel, Investment Company Institute, Washington, D.C., of counsel), *filed a*

brief on behalf of Investment Company Institute as Amicus Curiae.

HOGAN & HARTSON, Washington, D.C. (Neal L. Petersen, Keith R. Fisher, James G. Christiansen, Washington, D.C., of counsel), *filed a brief on behalf of Bank Capital Markets Association as Amicus Curiae.*

JOHN J. GILL, General Counsel, Washington, D.C. (Michael F. Crotty, Associate General Counsel-Litigation, American Bankers Association, Washington, D.C., of counsel), *filed a brief on behalf of the American Bankers Association as Amicus Curiae.*

CARDAMONE, *Circuit Judge*:

We review on this appeal those provisions of the Banking Act of 1933 that separated the commercial and investment banking industries and are known as the Glass-Steagall Act. *See* Pub. L. No. 73-66, §§ 16, 20, 21, & 32, 48 Stat. 162 (1933). Demand for divorcing banking and securities activities followed in the wake of the stock market crash of 1929, which occurred, it was said, because a mountain of credit rested on only a molehill of cash. The actions of the Federal Reserve Board that we review today allow commercial and investment banking to compete in a narrow market, and to that extent dismantle the wall of separation installed between them by the Glass-Steagall Act. Whether Santayana's notion

that those who will not learn from the past are condemned to repeat it fairly characterizes the consequences of the Board's action is not for us to say. Our task is to review the Glass-Steagall Act, the legislative history that surrounded its enactment, and its prior judicial construction to determine whether the Board reasonably interpreted the Act's often ambiguous terms.

The Securities Industry Association (SIA) and seven bank holding companies petition for review of six related orders of the Board of Governors of the Federal Reserve System (Board). The orders approved the bank holding companies' applications to utilize subsidiaries as the vehicle by which they can underwrite and deal in certain securities. The Board determined that the approved activities would not run afoul of § 20 of the Glass-Steagall Act, which proscribes affiliations of banks—here, the holding companies' member bank subsidiaries—with entities that are "engaged principally" in underwriting and dealing in securities. At the same time, the Board limited the scope of the approved activities. The decisions allowing bank subsidiaries to engage in securities transactions and the limitations that were imposed are the focus of the petitions seeking review. For the reasons set forth below, we deny the petitions for review save for the bank holding companies' cross-petition for review that seeks to eliminate the market share limitation.

BACKGROUND

I *The Board's Orders*

On April 30, 1987 the Board approved the applications of Citicorp, J.P. Morgan & Co., Inc., and Bankers Trust New York Corp. to engage in limited securities activities through wholly-owned subsidiaries. 73 Fed. Reserve Bull.

473 (1987). At the time of the applications, the subsidiaries were engaged entirely in underwriting and dealing in U.S. government and agency securities and those of state and municipal governments. The holding companies sought to extend their subsidiaries' activities to underwriting and dealing in municipal revenue bonds, mortgage related securities, consumer receivables related securities, and commercial paper.[1] With the exception of the consumer receivables, on which decision was deferred because of an insufficient record, the Board approved the applications by a vote of three to two. Limitations on the scope of the activities more restrictive than those initially proposed by the holding companies—to be discussed more fully below—were imposed.

On May 18, 1987 the Board approved the applications of four other bank holding companies, Chase Manhattan Corp., Chemical New York Corp., Manufacturers Hanover Corp., and Security Pacific Corp., to underwrite and deal in the same activities to the same extent approved in its April 30th order. 73 Fed. Reserve Bull. 607 (1987); *id.* at 616; *id.* at 620; *id.* at 622. With the exception of Chase Manhattan, each holding company then had an existing subsidiary currently engaged in underwriting and dealing in federal, state, and local government securities. Chase Manhattan's application included a request for its subsidiary to engage in government securities activities, which the Board approved. The Board also approved Citicorp's supplemental application to deal in commercial paper. *Id.* at 618.

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1 J.P. Morgan & Co. did not apply to underwrite or deal in consumer receivables related securities and Citicorp did not propose to engage in activities relating to commercial paper.

SIA, a trade association representing securities brokers, dealers, and underwriters, petitioned for review of the April 30th and May 18th orders, arguing that the approved activities would violate § 20 of the Glass-Steagall Act. The holding companies cross-petitioned challenging the Board imposed limitations. We granted a stay of the orders on May 19, 1987 pending this expedited appeal.

II *The Board's Analysis*

The bank holding companies' applications were made pursuant to § 4(c)(8) of the Bank Holding Company Act of 1956, which allows a bank holding company to acquire the "shares of any company the activities of which the Board . . . has determined . . . to be so closely related to banking . . . as to be a proper incident thereto." 12 U.S.C. § 1843(c)(8) (1982). The determination that the approved securities activities are closely related to banking is not contested on this appeal. Rather, since the Board's discretion under § 4(c)(8) is limited by the Glass-Steagall Act, *cf. Board of Governors of Fed. Reserve Sys. v. Investment Co. Inst.*, 450 U.S. 46, 76-77 (1981) (*ICI*), the principal issue before the Board was whether the approval of the activities would contravene that Act.

Section 20 of the Glass-Steagall Act forbids a member bank of the Federal Reserve System from affiliating with an organization "engaged principally" in, *inter alia*, underwriting or dealing in securities. 12 U.S.C. § 377 (1982). Bank holding companies have been allowed since 1978—without a court challenge by SIA—to acquire or form subsidiaries that underwrite and deal in securities representing obligations of the United States and of states and their political subdivisions. *See*, *e.g.*, *United Bancorp*, 64 Fed. Reserve Bull. 222 (1978); *see also* 12 C.F.R.

§ 225.25(b)(16) (1987) (regulation permitting such activity). Section 16 of the Glass-Steagall Act expressly permits banks themselves to underwrite and deal in these governmental securities, known as "bank-eligible securities." 12 U.S.C. § 24 (Seventh) (1982 & Supp. IV 1986).

Given the authorization in § 16 for banks to engage in bank-eligible securities activities, the Board concluded that Congress did not aim in § 20 to proscribe bank affiliates from engaging in the same activities. 73 Fed. Reserve Bull. at 478-81. It reasoned that it would be anomalous not to permit the bank's subsidiary to engage in the activities lawfully permitted the bank. That illogical result necessarily follows if bank-eligible securities are defined as "securities" under § 20 because that section prohibits a member bank from being affiliated with an organization "engaged principally" in securities dealing. Hence, according to the Board, "securities" cannot logically mean bank-eligible securities. "Securities" in § 20 must therefore only refer to those types of securities that under § 16 banks cannot themselves deal in or underwrite, known as "bank-ineligible securities." The activities approved in the orders at issue on this appeal—underwriting and dealing in municipal revenue bonds, mortgage related securities, and commercial paper—cannot be conducted by a member bank and are therefore bank-ineligible securities activities.

Establishing as a predicate that the proscription in § 20 extends only to bank-ineligible securities, the Board turned to the question of when an affiliate is "engaged principally" in such activity. Relying on its order in *Bankers Trust New York Corp.*, 73 Fed. Reserve Bull. 138

(1987),[2] the Board held that the term "engaged principally" means any substantial activity. 73 Fed. Reserve Bull. at 482. It then concluded that subsidiaries would not be engaged substantially in bank-ineligible activities if no more than five to ten percent of their total gross revenues was derived from such activities over a two-year period, and if the activities in connection with *each* type of bank-ineligible security did not constitute more than five to ten percent of the market for that particular security. *Id.* at 485-86. The Board then proceeded to approve gross revenue and market share levels at five percent—the low end of the acceptable range—but stated that it would review the five percent limitations within a year after the implementation of its orders. The applicants wanted, of course, to engage in higher levels of activity.

On review, SIA argues that the Board erroneously construed the Glass-Steagall Act by construing the word "securities" in § 20 not to include bank-eligible securities. In other words, SIA contends that § 20 limits both bank-eligible *and* bank-ineligible security activities by a member bank affiliate. SIA also objects to the Board's construction of "engaged principally." The bank holding companies urge us to adopt the Board's construction of § 20 with regard to "securities", but argue, at the same time, that the Glass-Steagall Act mandates that the Board allow a higher level of bank-ineligible activity than that approved.

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2 Petitions for review of this order are pending in the United States Court of Appeals for the District of Columbia Circuit.

THRESHOLD MATTERS

I *The Moratorium*

Subsequent to the stay granted in this case, Congress enacted and the President signed into law on August 10, 1987 the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (CEBA),[3] the provisions of which impose a moratorium period, effective retroactively, prohibiting the Board from approving affiliate involvement in certain securities transactions. Section 201(b) provides that between March 6, 1987 and March 1, 1988,

> (2) A Federal banking agency may not authorize or allow by action, inaction, or otherwise any bank holding company or subsidiary or affiliate thereof . . . to engage in the United States to any extent whatever—
>
> (A) in the flotation, underwriting, public sale, dealing in, or distribution of securities if that approval would require the agency to determine that the entity which would conduct such activities would not be engaged principally in such activities . . . .

CEBA, § 201(b), 101 Stat. at 582 (to be codified at 12 U.S.C. § 1841 note).

Under § 202 the Board may issue an order during the moratorium period pursuant to its authority in existence before CEBA "if the effective date of such . . . order is delayed until the expiration of such moratorium." 101

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3 In September the panel wrote to counsel requesting them to advise whether in light of CEBA this appeal remains viable. All counsel promptly responded by early October, 1987 that in their view the appeal was not mooted by the moratorium legislation.

Stat. at 584 (to be codified at 12 U.S.C. § 1841 note). According to the Joint Explanatory Statement of the Conference Committee to fall within this exception an order "must contain or otherwise be subject to" a specification "that the powers in question may not be exercised before the moratorium has expired." H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 149 (1987), *reprinted in* 1987 U.S. Code Cong. & Admin. News 588, 618.

Each order subject to our review was issued during the moratorium period and each approved of activities covered by § 201. Nevertheless, the Board noted in its April 30th order that it was aware that Congress might impose the moratorium and that there might be an exception for orders that delay the effective date. 73 Fed. Reserve Bull. at 502. The Board then called to the applicants' attention that subsequent legislation might require them to cease the approved activities in the event of a moratorium and also retained jurisdiction "to act to carry out the requirements of any legislation adopted by Congress" that affected the activities approved under the order. *Id.* Identical explanations and caveats appear in the other orders relevant to this appeal. Thus, their effective date effectively was delayed in the event of a moratorium, as mandated by § 202. CEBA therefore in no way precludes our review of the substantive issues presented in these petitions. Before considering them, we discuss briefly the applicable standard of review.

II *Standard of Review*

The starting point for reviewing an agency's construction of a statute is the language of the statute. *See, e.g., Federal Deposit Ins. Corp. v. Philadelphia Gear Corp.*, 106 S. Ct. 1931, 1934 (1986); *Board of Governors of the*

Fed. Reserve Sys. v. Dimension Fin. Corp., 474 U.S. 361, 368 (1986); *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). An agency's construction of unambiguous statutory language is never an issue because the clear language of the statute must be given effect by the agency and the courts. *See Chevron*, 467 U.S. at 842-43 ("If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."). Only when the statutory language is ambiguous must a court inquire whether the agency's construction is permissible. *Id.* at 843. If the Board's interpretation of the Glass-Steagall Act is reasonable its decision must be upheld. *See Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 716 F.2d 92, 95 (2d Cir. 1983) ("Because the Board has both primary responsibility for implementing the Glass-Steagall Act and expert knowledge of commercial banking, we must uphold its interpretation of the Act if it is reasonable."), *aff'd*, 468 U.S. 207 (1984). Thus, the first question is whether § 20 is ambiguous.

The Board readily concedes that the term "securities" in § 20 could be read to include not only those securities that banks are expressly permitted to underwrite or deal in, that is, bank-eligible securities, but also those that banks are not entitled to underwrite or deal in, that is, bank-ineligible securities. Unlike § 16—which expressly distinguishes bank-eligible from bank-ineligible securities—§ 20 does not distinguish the terms. Hence, at least on the surface § 20 would appear to refer to both kinds of securities.

But a closer examination of Glass-Steagall leads us to reject this conclusion. In the first place, the Act makes

three different references to the term "securities." Section 16 distinguishes bank-eligible from bank-ineligible securities. 12 U.S.C. § 24 (Seventh) (1982 & Supp. IV 1986). Repealed § 19(e), discussed *infra* note 4, referred to "securities *of any sort*." 48 Stat. at 188 (emphasis added). And §§ 20 and 32 refer simply to "securities." 12 U.S.C. § 377 (1982) (§ 20); 48 Stat. at 194 (codified as amended at 12 U.S.C. § 78 (1982)) (§ 32). That Congress chose three distinctively different ways to describe securities raises a red flag that cautions against declaring that the meaning of that term in § 20 is clear.

Further support for the proposition that § 20 is uncertain is provided by the subsequent amendment to § 21 of Glass-Steagall. Section 21 originally did not expressly exempt bank-eligible securities as did § 16. A 1935 amendment made it plain that § 21 did not prevent that which § 16 permitted. *See* Banking Act of 1935, Pub. L. No. 74-305, § 303, 49 Stat. 684, 707. The significance of this to the issue of § 20's ambiguity is that the amendment was only intended to *clarify* existing law, *see, e.g.*, H.R. Rep. No. 742, 74th Cong., 1st Sess. 16 (1935); S. Rep. No. 1260, 73d Cong., 2d Sess. 2 (1934); *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 807 F.2d 1052, 1057-58 (D.C. Cir. 1986) (*Bankers Trust II*), *cert. denied*, 107 S. Ct. 3228 (1987), and did not purport to effect any substantive change. But, if the 1935 amendment was not intended to alter the substance of § 21, it follows that the Congress that enacted Glass-Steagall did not invariably make an explicit distinction between bank-eligible and bank-ineligible securities, even when it aimed to distinguish them from one another. Based on this, we can conclude with some confidence that Congress' reference in § 20 to "securities" is ambiguous,

and undertake to decide whether the Board's interpretation of securities in § 20 is reasonable and therefore entitled to deference.

Of course, "deference is not to be a device that emasculates the significance of judicial review." *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 137, 142-43 (1984) (*Bankers Trust I*). One factor militating against deference to the Board's definition of securities is its failure to address an apparent contradiction, discussed below, between its interpretation of § 20 and its prior view of § 32. This failure implicates two factors that courts take into consideration in deciding whether to accord deference to an administrative agency charged with implementing a statute: first, "the thoroughness, validity, and consistency of an agency's reasoning," *Federal Election Comm'n v. Democratic Senatorial Campaign Comm.*, 454 U.S. 27, 37 (1981), and, second, the consistency of the agency's present interpretation with its earlier pronouncements, *Morton v. Ruiz*, 415 U.S. 199, 237 (1974); *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

The Board should have examined § 32 in its analysis of § 20 because—as the Supreme Court has indicated—"§§ 32 and 20 contain identical language, were enacted for similar purposes, and are part of the same statute." *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 207, 219 (1984) (*Schwab*). Thus, an established interpretation of the language of one section is important in interpreting the language of the other. *See id.* In that respect, the Board's 120-page opinion is deficient.

The Board's earlier view of § 32 suggests that bank-eligible securities were *included* within the term "securi-

ties" in § 32. In 1936 the Board exempted from § 32 individuals dealing in or underwriting "bonds, notes, certificates of indebtedness, and Treasury bills of the United States." 22 Fed. Reserve Bull. 51, 52 (1936). As SIA argues, this suggests that the Board understood that bank-eligible securities were covered by § 32, because there was otherwise no need to exempt from § 32 individuals involved in those securities activities. At oral argument the Board's response to SIA's contention was that it had merely failed to explain its reasoning for the exemption, and that granting the exemption from the prohibitions of § 32 was done only for purposes of clarity.

This could be a plausible explanation, but in this instance we think it is not. Although in its current form Regulation R does exempt from § 32 individuals engaged in any securities activity permitted to banks under § 16, *see* 12 C.F.R. § 218.2 (1987), the exemption, as originally enacted, did not exempt *all* forms of bank-eligible securities, but only the obligations of the United States. Omitted from exemption were the general obligations of the States or their political subdivisions. *See* 22 Fed. Reserve Bull. at 52. From this it is obvious that the Board did not read § 32 as excluding *ab initio* all bank-eligible securities, but rather that it exercised the authority granted it by Congress under § 32—authority not granted in § 20—to create a narrow exemption for individuals dealing in United States government obligations. In addition, in a footnote to the 1936 regulation, the Board enumerated instances in which the terms of § 32 did not apply. *See* 22 Fed. Reserve Bull. at 51 n.1. Plainly, the Board knew how to say when § 32 did not apply to a certain activity, and how to state that a certain activity was subject to § 32,

but was nevertheless *exempted* pursuant by the Board under its statutory authority.

The Board's orders on appeal here are not instances where the Board failed to adopt an expressly articulated position on the meaning of § 20. *Cf. Investment Co. Inst. v. Camp*, 401 U.S. 617, 627-28 (1971) (*Camp*). Nonetheless, its failure to address—in what is an otherwise comprehensive and reasoned decision—the significance of its prior interpretation of § 32 counsels against granting it full deference. Our own review of the history of the Glass-Steagall Act leads us nonetheless to conclude that construing § 20 as not encompassing activities by bank affiliates in bank-eligible securities is essential if Congress' purpose in enacting § 20 is to be effectuated.

DISCUSSION

The two principal issues presented to this court are the Board's constructions of the terms "securities" and "engaged principally" under § 20 of the Glass-Steagall Act. The proper interpretation of § 20 is an issue of first impression and necessitates a comprehensive examination of both the relevant legislation and the events surrounding its enactment.

I *Glass-Steagall: A Statutory Overview*

The whole of the Banking Act of 1933, ch. 89, Pub. L. No. 73-66, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.), is sometimes referred to as the Glass-Steagall Act. *See ICI*, 450 U.S. at 53. It is perhaps more accurate to consider §§ 16, 20, 21, and 32 of the Banking Act of 1933 in particular as the Glass-Steagall Act. *See Schwab*, 468 U.S. at 216 & n.15. These sections, the " 'Maginot Line' of the financial world," *see*

Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 Emory L.J. 1, 5 (1984) [hereinafter *Glass-Steagall Dilemma*] (quoting Bevis Longstreth, "Current Issues Facing the Securities Industry and the SEC," May 4, 1982 speech to the SIA), were meant to separate commercial and investment banking.[4]

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4 The Glass-Steagall Act originally contained a fifth section—§ 19(e)—which also was designed to effect a separation between commercial and investment banking. It read in pertinent part:

> (e) Every such holding company affiliate shall, in its application for such voting permit, (1) show that it does not own, control, or have any interest in, and is not participating in the management or direction of, any corporation, business trust, association, or other similar organization formed for the purpose of, or engaged principally in, the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail or through syndicate participation, of stocks, bonds, debentures, notes, or other securities of any sort (hereinafter referred to as 'securities company'); . . .

Pub. L. No. 73-66, ch. 89, § 19(e), 48 Stat. 162, 188 (1933), *repealed*, Pub. L. No. 89-485, § 13(c), 80 Stat. 236, 242 (1966).

Thus, § 19(e) was the Glass-Steagall Act provision that originally dealt with bank holding companies. Section 19(e) operated indirectly; bank holding companies were required to apply to the Reserve Board for a permit entitling them to exercise the voting rights of the shares of stock which they held in member banks. *See* 48 Stat. at 186. In order to obtain a voting permit, a bank holding company had to divest itself of ownership or control of its securities affiliate(s). The reason for this indirect method was Congress' hesitancy to legislate in regard to state-chartered institutions. *See* S. Rep. No. 77, 73d Cong., 1st Sess. 10 (1933); 75 Cong. Rec. 9905 (1932) (remarks of Sen. Walcott). Yet, § 19(e) was largely ineffectual because bank holding companies simply elected not to vote the shares of their securities affiliates. *See ICI*, 450 U.S. at 69-70. In addition, after the enactment of the Bank Holding Company Act of 1956, which broadened the Banking Act's definition of "affiliate," it became doubtful whether § 19(e) was "sufficiently useful to justify [its] retention." S. Rep. No. 1179, 89th Cong., 2d Sess. 12 (1966). The "loophole" therefore was closed by a 1966 amendment. *See* 80 Stat. at 242.

Section 16 of the Glass-Steagall Act applies to federally chartered banks and restricts their powers. In pertinent part, the statute as amended provides:

> The business of dealing in securities and stock by the [member bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [member bank] shall not underwrite any issue of securities or stock . . . . The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof . . . .

12 U.S.C. § 24 (Seventh) (1982 & Supp. IV 1986).

As can be readily seen, § 16 forbids national banks from underwriting "any issue of securities or stock"[5] and also limits their ability to deal in securities. As noted, it expressly excepts from its coverage underwriting and dealing in the obligations of the United States or general obligations of states or their political subdivisions, which we have termed "bank-eligible securities."

Section 21 seeks to draw the same line as § 16 does for commercial banks, but from the perspective of investment banks. *See Bankers Trust I*, 468 U.S. at 148. Section 21 as amended reads in pertinent part:

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5 As it was originally written, § 16 only prohibited underwriting "securities." *See* 48 Stat. at 185 (1933). One of the so-called "technical" provisions of the Banking Act of 1935 amended § 16 by adding "and stock" after the references to "securities." Banking Act of 1935, Pub. L. No. 74-305, ch. 614, tit. III, § 308(a), 49 Stat. 684, 709 (1935).

(a) After the expiration of one year after June 16, 1933, it shall be unlawful—

(1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor: *Provided*, That the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of section 24 of this title . . . .

12 U.S.C. § 378(a)(1) (1982). Section 21 prohibits firms "*engaged*" in certain investment banking activities from undertaking commercial banking activities. *See Bankers Trust I*, 468 U.S. at 148; *ICI*, 450 U.S. at 62-63. As originally drafted and enacted it did not contain the § 16 proviso that allowed banks to underwrite and deal in bank-eligible securities. *See* Banking Act of 1933, § 21, 48 Stat. at 189. A 1935 amendment to § 21 made explicit that § 21 did not prohibit those activities permitted member banks under § 16. *See* Banking Act of 1935, Pub. L. No. 74-305, ch. 614, tit. III, § 303(a), 49 Stat. 684, 707 (1935).

Sections 32 and 20 are the Glass-Steagall Act's "remaining ramparts" in the line between commercial and investment banking. *Glass-Steagall Dilemma*, *supra*, at 6. Section 32 as amended reads in its entirety:

> No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, *primarily engaged* in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.

12 U.S.C. § 78 (1982) (emphasis added). Section 32 prohibits personnel "interlocks" between member banks and firms that are "*primarily engaged*" in the business of underwriting or dealing in securities. In its original form, the section authorized the Board to permit an individual exemption from the prohibitions of § 32. *See* Banking Act of 1933, § 32, 48 Stat. at 194. In 1935 Congress amended § 32 to allow the Board to promulgate a general regulation to exempt "classes of cases" from the reach of § 32. *See* Banking Act of 1935, § 307, 49 Stat. at 709. In 1936 the Board promulgated Regulation R, which exempted from § 32 individuals dealing in "bonds, notes, certificates of indebtedness, and Treasury bills of the United States." *See* 22 Fed. Reserve Bull. 51, 52 (1936).

The current version of Regulation R is found at 12 C.F.R. § 218.2 (1987).

Finally, § 20—the proper interpretation of which is the principal question presented on this appeal—provides in pertinent part:

> After one year from June 16, 1933, *no member bank shall be affiliated* in any manner described in subsection (b) of section 221a of this title *with any* corporation, association, business trust, or other similar *organization engaged principally in the issue*, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation *of stocks, bonds, debentures, notes, or other securities* . . . .

12 U.S.C. § 377 (1982) (emphasis added). As discussed above, the Board concluded that § 20 only proscribes member bank affiliation with firms "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of *bank-ineligible* securities, those which banks are prevented under § 16 from dealing in themselves. Throughout this opinion we have adopted, for clarity's sake, the term "underwriting and dealing in" to refer to "the issue, flotation . . ." language in § 20.

II *The Meaning of "Securities" in § 20*

When called upon to interpret the Glass-Steagall Act, judges "face a virtually insurmountable burden due to the vast dichotomy between the ostensible legislative intent and the actual motivations of Congress." *Glass-Steagall Dilemma*, *supra*, at 1-2. Divining the aim of Congress in enacting § 20 is particularly formidable because the issue of the proper relationship between commercial banks and

their affiliates caused considerable disagreement among legislators and experts who participated in the development of what became the Banking Act of 1933. *See generally* Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 Banking L.J. 483, 505-12 (1971) [hereinafter *Banking Divorce*]. Consequently, we approach the subject first by examining the legislative history of § 20, analyzing the Congressional compromise that resulted in the enactment of § 20, and then by looking at prior judicial construction of the Act.

A. *Legislative History*

1. *Envisioning § 20—Congress' Purpose*

The Act's legislative history reflects the notion that the underlying cause of the stock market crash in 1929 and subsequent bank insolvencies came about from the excessive use of bank credit to speculate in the stock market. *See* S. Rep. No. 77, 73d Cong., 1st Sess. 3-9 (1933) [hereinafter *1933 Senate Report*]; *see also* 75 Cong. Rec. 9883-84 (1932) (remarks of Sen. Glass) (criticizing transformation of the Federal Reserve System from a commercial banking system into one used for "stock-market speculative operations"). Bank affiliates were identified as a major factor in the overextension of credit for security loans. *See 1933 Senate Report*, *supra*, at 9-10.

Congress' concern was not limited solely to how securities affiliates contributed to the excesses in bank credit; its apprehension was far more fundamental and structural. Senator Bulkley, for example, repeatedly stressed that the debate over affiliates should not obscure "[t]he important and underlying question [of] whether banking institutions receiving commercial and savings deposits ought to be permitted at all to engage in the investment-security

business." 75 Cong. Rec. 9910 (1932). He argued that "[t]he existence of security affiliates is a mere incident to this question," *id.*, and reiterated that "the real question is not whether . . . banks shall be permitted to have investment-security affiliates but rather whether they should be permitted to engage in the investment-security business in any manner at all, through affiliates or otherwise," *id.* at 9911.

Two large problems attendant upon the involvement of a commercial bank in investment banking—either on its own or through use of an affiliate—were identified by Congress. The first was "the danger of banks using bank assets in imprudent securities investments." *ICI*, 450 U.S. at 66; *see also Camp*, 401 U.S. at 630. The second "focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments." *Camp*, 401 U.S. at 630.

In *Camp* the Supreme Court described these subtle hazards: loss of public confidence in a bank if its affiliate lost money; the temptation for a bank to shore up an affiliate through unsound loans; imprudent lending to companies in which the security affiliate has invested or become interested; possible loss of a bank's goodwill should its depositors suffer losses on investments that they purchased in reliance on the relationship between the bank and its affiliate; bank loans used for purposes of buying securities; commercial bank involvement in investment banking which might facilitate the loss of disinterested investment advice and encourage violations of fiduciary obligations. *Camp*, 401 U.S. at 631-33; *see*

Operation of the National and Federal Reserve Banking Systems, Hearings on S. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency, 71st Cong., 3d Sess. 1063-64 (1931) [hereinafter *1931 Hearings*]; 75 Cong. Rec. 9911-12 (1932) (remarks of Sen. Bulkley).

Sections 16 and 21 effectively barred commercial banks from *direct* engagement in investment banking, with the notable exception of government securities. Yet even before the 1929 crash, direct involvement by a bank had been considered "improper," *see Camp*, 401 U.S. at 629, but bank affiliates had developed as the medium for commercial banks' *indirect* entry into investment banking, *see id.* Even though the stock market debacle laid bare the dangers arising from the activities of securities affiliates, opinion was divided on how best to mitigate those dangers.

No one argued that the affiliate system had not been abused in the past, *see, e.g.*, *1931 Hearings*, *supra*, at 298-99 (remarks of Charles E. Mitchell, Chairman, National City Bank of New York). Experts believed that an adequate check on such abuse was to establish rigorous examination requirements for affiliates, which had remained largely unregulated before 1929. *See, e.g.*, *id.* at 117 (testimony of J.H. Case, Chairman, Board of Directors of the Federal Reserve Bank of New York); *id.* at 192 (testimony of A.H. Wiggin, Chairman of the Governing Board, Chase National Bank); *id.* at 364 (testimony of O.D. Young, Chairman of the Board, General Electric Co.); *id.* at 405 (testimony of M.W. Traylor, Chairman of the Board, First National Bank of Chicago). Others thought that if the slate were wiped clean, affiliates should not be legal, but that in 1933 a complete divorce between commercial and investment banking was not

feasible given the established role of affiliates in the banking system. *See, e.g., id.* at 22 (testimony of J. Pole, Comptroller of the Currency); *id.* at 38-39 (testimony of G.L. Harrison, Governor, Federal Reserve Bank of New York); *id.* at 148 (testimony of A.C. Miller, Member, Federal Reserve Board).

Some advocated complete separation of the commercial and investment banking industries. *See, e.g., id.* at 231 (testimony of B.W. Trafford, Vice Chairman, First National Bank of Boston). Senator Glass—an adherent of this view—was of the opinion that a "complete separation" was both warranted and capable of being accomplished. *E.g., Operation of the National and Federal Reserve Banking Systems, Hearings on S.4115 Before the Senate Comm. on Banking and Currency*, 72d Cong., 1st Sess. 42, 267 (1932) (remarks of Sen. Glass) [hereinafter *1932 Hearings*]. Senator Glass' views are significant, of course, because of his role in drafting and shaping the Banking Act of 1933, a portion of which bears his name. *Cf. North Haven Bd. of Educ. v. Bell*, 456 U.S. 512, 526-27 (1982) (remarks of sponsor of language ultimately enacted "are an authoritative guide to the statute's construction"). Yet, despite the Senator's goal of complete separation, the Senate took a less drastic step. Acknowledging that "[i]t has been suggested . . . that the affiliate system be simply 'abolished,' " the Senate rejected this as impossible and stated that its goals toward regulating affiliates were to (1) separate "*as far as possible*" member banks from affiliates of all kinds; (2) limit advances or loans from parent to affiliate; and (3) install satisfactory examination requirements for affiliates. *1933 Senate Report, supra*, at 10 (emphasis added).

2. *Construing § 20—Congress' Compromise*

Section 20 was Congress' solution to the problem of affiliates and establishes the boundary separating banks from their security affiliates. While § 21 prohibits firms "engaged" in investment banking activities from accepting deposits, § 20 prohibits commercial bank affiliation with firms "engaged principally" in underwriting and dealing in securities. The inference following from this different terminology is obvious: § 20 applies a "less stringent standard" than the absolute bar between commercial and investment banking laid down by §§ 16 and 21. *ICI*, 450 U.S. at 60 n.26. Nor can the difference in terminology be attributed to oversight. Section 21 originally contained the term "engaged principally." In offering the amendment that deleted "principally," Senator Bulkley argued that "[i]t has become apparent that at least some of the great investment houses are engaged in so many forms of business that there is some doubt as to whether the investment business is the principal one." 77 Cong. Rec. 4180 (1933). Given that one of the leading advocates of Glass-Steagall recognized that "engaged" connoted a stricter standard than "engaged principally," it is inconceivable that the latter term could remain in § 20 by sheer happenstance. Thus, while the original impetus behind the Glass-Steagall bill on the floor of Congress may have been to sever completely the commercial and investment banking industries, it fell short of that goal—a victim of legislative compromise.

Legislative history also supports the view that § 20's use of the word "securities" did not imply a complete separation between commercial and investment banking. A colloquy between Senators Glass and Long is illuminating:

MR. LONG. I have been told that the Senator has said that he did not think this bill would prohibit the handling of Government and State bonds by the Federal reserve banks, that the Senator's provision against affiliates handling bonds was not intended to affect the handling of Government and State bonds.

MR. GLASS. They are expressly excluded from the terms of the bill.

MR. LONG. As to both affiliates and the banks?

MR. GLASS. As to affiliates? We are trying to abolish the affiliates in a period of years.

MR. LONG. The Senator has no objection, has he, to an affiliate handling them if they handle nothing but the Government and State Bonds under supervision, the same supervision the banks are given?

MR. GLASS. I am objecting to affiliates altogether. I am objecting to a national banking institution setting up a back-door arrangement by which it may engage in a business which the national bank act denies it the privilege of doing. If investment banking is a profitable business, who does not know that such business will be set up as a separate institution, not using the money and prestige and facilities of a national bank and its deposits to engage in investment activities? I want to make it impossible hereafter to have the portfolios of commercial banks filled with useless speculative securities, so that when stringency comes upon the country these banks may not respond to the requirements of commerce. That is what is the matter with the country to-day, and it is because this bill would avert a repetition of that

> disaster that intense and bitter opposition has been organized against it.

76 Cong. Rec. 2000 (1933). Senator Glass' aspiration to divorce completely commercial banks from their security affiliates was never attained: § 20 only prohibits affiliation with firms that are "engaged principally" in forbidden investment activity. SIA urges from the above colloquy that Senator Glass objected to affiliates' handling even securities that banks themselves could underwrite under the proposed legislation and that the Senator's view carried the day in § 20 as enacted. On the contrary, we believe Senator Glass' response to Senator Long indicates that he was primarily concerned with "back-door" arrangements between banks and their security affiliates that permitted affiliates to engage in the securities business denied by law to the bank itself. Senator Glass' reservation did not encompass affiliate activity in a business that § 16 grants to a bank "the privilege of doing."

Further, Senator Long's initial query indicates that the issue of whether affiliates ought to be able to engage in bank-eligible activities to the same extent as banks themselves was not dormant during the debates. Thus, Senator Long commented that those who had opposed some provisions in the bill "have seen some virtue in it. I particularly refer to the divorcing of the affiliates, except in so far as they handle municipal and Government bonds and securities." 76 Cong. Rec. 2274 (1933). To make certain affiliates had the same right to deal in government obligations, Senator Long had printed and circulated an amendment to the Glass-Steagall bill to that effect. Proposed Amend. to S. 4412, 72d Cong., 2d Sess. (Jan. 10, 1933). Despite Senator Long's repeated insistence that

§ 20 would not preclude bank-eligible activities by an affiliate, this amendment was never formally raised in debate. The Banking Act of 1933 became law five months later, on June 16, 1933, and it can be plausibly urged that the bill finally agreed upon and enacted into law made his amendment unnecessary. Recognizing the power of Senator Long's position, SIA argues that statements and actions taken during debate are not entitled to much weight. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 n.24 (1976). A look at subsequent events in this case illustrates the soundness of that rule. In 1935, just two years after his strong rhetoric in the Banking Act debate, Senator Glass himself supported a proposed amendment to that law granting to commercial banks the right to underwrite securities. 79 Cong. Rec. 11,827 (1935). So much for not having "the portfolios of commercial banks filled with useless securities."

Thus, it seems eminently reasonable to conclude from Senator Glass' response to Senator Long, as well as other evidence in the legislative history, that Congress' concern was primarily with bank affiliate activities in bank-ineligible securities. Bank affiliates often "devote[d] themselves . . . to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock often largely with the resources of the parent bank." *1933 Senate Report, supra*, at 10. According to Senator Glass, "[w]hat the committee had foremost in its thought was to exclude from commercial banking all investment securities except those of an undoubted character that would be surely liquidated; and for that reason we made an exception [in § 16] of United States securities and of the general liabilities of States and subdivisions of States." 76 Cong. Rec. 2092 (1933). Given that Glass-

Steagall was a means to sever commercial banking only from more speculative, "perilous" investment activities, in which bank-eligible activities were not included, an interpretation of "securities" in § 20 that excludes bank-eligible securities from its reach is entirely consistent with Congress' aim.

The history of security affiliates in the United States also supports this view. Many banks formed security affiliates in order to handle the sale of government bonds used to finance World War I. B. Klebaner, *Commercial Banking in the United States: A History* 109-10 (1974); *Banking Divorce*, *supra*, at 490-91; *see also 1932 Hearings*, *supra*, at 29 (testimony of A.M. Pope, President, Investment Bankers' Ass'n of Am.). Banks were "expected" to aid the government in distributing war loans and were "encouraged" to aid potential investors by lending them the purchase price of government bonds. *Banking Divorce*, *supra*, at 491. It was not until the 1920's that affiliates began to expand into private debt and equity securities activities in response to the demands of the public and business. *See id.* at 493-96; *see also* 77 Cong. Rec. 3835 (1933) (remarks of Rep. Steagall) ("Our great banking system was diverted from its original purposes into investment activities, and its service devoted to speculation and international high finance."); 75 Cong. Rec. 9904-05 (1932) (remarks of Sen. Walcott) (businesses began to finance their requirements by sale of securities rather than by borrowing; growth of affiliates was "the outgrowth of the willingness of public to buy readily and without very much inquiry"). It was not the affiliate system as a concept that worried Congress, but the affiliate system as it had developed. The evil that Congress intended to attack was bank involvement in specula-

tive securities, that is, bank-ineligible securities. We cannot attribute to Congress a purpose to limit *all* securities activities when it consistently made clear that it was only concerned with *one type*.

An elucidation of SIA's suggested interpretation of § 20 shows the anomalies that an over-literal interpretation of the term "securities" in that section might bring. If bank-eligible securities are included in the prohibitions of § 20, an affiliate could "engage" (but not principally) in bank-ineligible securities activities. Alternatively, the same affiliate could engage to the identical extent in bank-eligible securities activities. SIA's construction would permit either, or both, types of activity—up to a certain point. Two banks could each have an affiliate, one engaged in underwriting and dealing in high-risk securities prohibited to banks, and the other engaged in the government obligations that Congress felt to be of such negligible risk that it allowed, and encouraged, banks themselves to deal in them. It is paradoxical to presume that it was Congress' purpose to place both affiliates on the same footing.

A subsequent amendment to the Glass-Steagall Act also argues against too strict a construction of § 20. As mentioned earlier, Congress amended § 21 in 1935 to "make it clear that [§ 21] does not prohibit any financial institution or private banker from engaging in the securities business" to the extent permitted in § 16. H.R. Rep. No. 742, 74th Cong., 1st Sess. 16 (1935); *see also* S. Rep. No. 1007, 74th Cong., 1st Sess. 15 (1935); S. Rep. No. 1260, 73d Cong., 2d Sess. 2 (1934). SIA claims that because § 20 was also amended at the same time, *see* H.R. Rep. No. 742, 74th Cong., 1st Sess. 16 (1935) (amendment to § 20 regarding formalities of affiliate liquidation), the

failure to add to § 20 a similar proviso indicates a deliberate legislative determination that § 16 activities are within the scope of § 20. We cannot agree.

First, this argument belies the *clarifying* nature of the amendment to § 21. *See Bankers Trust II*, 807 F.2d at 1057-58. Second, we decline to hold that in failing to amend § 20 in the same manner Congress planned to clarify the meaning of the term "securities" by its silence. There is evidence that the Banking Act of 1933 itself was not the driving force that caused banks to divest themselves of their affiliates. Instead, economic conditions and Congress' investigation into stock market practices were instrumental in bringing banks to divorce themselves *voluntarily* from their affiliates. *See* B. Klebaner, *supra*, at 140; *Banking Divorce*, *supra*, at 522-24. Given this voluntary divestiture, § 20 became much less of a controversy in practice than it had been in legislative debate. Viewed in that perspective, it is not so unusual that Congress failed to amend § 20 in order to "clarify" the intent of that section as it had with § 21.

Finally, amicus Investment Company Institute (ICI) argues that repealed § 19(e)'s definition of securities—"securities of any sort"—confirms that "securities" in § 20 must mean both bank-eligible and bank-ineligible securities. To the contrary, "securities of any sort" is just as ambiguous as the word "securities" standing alone, and the phrase is vulnerable to the same construction as that advanced for § 20.

Thus, the legislative history strongly supports the view that "securities" in § 20 only refers to bank-ineligible securities.

B. *Prior Judicial Construction*

The compromise aspect of § 20 exposes the difficulties of fitting this case comfortably within the traditional "subtle hazards" analysis developed in *Camp* and used by the Supreme Court in subsequent Glass-Steagall Act cases. Under this analysis, the Court noted the hazards that Congress sought to prevent when the Act was passed and then examined whether a particular activity would implicate them. *See Schwab*, 468 U.S. at 220-21; *Bankers Trust I*, 468 U.S. at 154-60; *ICI*, 450 U.S. at 66-68; *Camp*, 401 U.S. at 630-34. By using in § 20 the language "engaged principally" rather than a more restrictive term, Congress expressed a legislative choice to tolerate at least some of those hazards. This situation is not entirely inconsistent with subtle hazards analysis—which never controlled the result in a Glass-Steagall case but only reinforced a conclusion already reached as a matter of statutory interpretation. *See Bankers Trust II*, 807 F.2d at 1069. Nor, for that matter, has the existence of one hazard required reversal of the Board: a hazard need not "be 'totally obliterated' to permit a banking practice—avoidance of the hazard 'to a large extent' suffices." *Id.* (quoting *ICI*, 450 U.S. at 67 n.39).

Accordingly, in reviewing the Board's determination that § 20 does not encompass bank-eligible securities, we give due regard not only to the hazards inherent in affiliation, but also to the manner in which Congress ultimately addressed those hazards through § 20. *See Commissioner v. Engle*, 464 U.S. 206, 217 (1984); *Southeastern Community College v. Davis*, 442 U.S. 397, 411 (1979). As the Supreme Court stated in *Board of Governors of the Federal Reserve System v. Dimension Financial Corp.*, 474 U.S. 361 (1986):

> Application of "broad purposes" of legislation at the expense of specific provisions ignores the complexity of the problems Congress is called upon to address and the dynamics of legislative action. Congress may be unanimous in its intent to stamp out some vague social or economic evil; however, because its Members may differ sharply on the means for effectuating that intent, the final language of the legislation may reflect hard-fought compromises. Invocation of the "plain purpose" of legislation at the expense of the terms of the statute itself takes no account of the processes of compromise and, in the end, prevents the effectuation of congressional intent.

474 U.S. at 373-74.

In light of these principles, the Court's subtle hazards analysis does not preclude the Board's construction of § 20. As noted, Congress was not concerned with affiliation *per se*, but rather with the dangers attendant upon the entry of commercial banks into the investment banking field either directly or indirectly. Yet even after acknowledging these perils, Congress allowed banks to underwrite and deal in bank-eligible securities under § 16, making it plain therefore that it believed the risks were not so great when banks dealt in these securities. As Senator Bulkley stressed, whether or not a bank chooses to engage in these activities itself or through an affiliate is relatively unimportant compared to the question of whether a bank should engage in them at all. Since banks are allowed under § 16 to underwrite and deal in government obligations without limitation, it would be incongruous for § 20 to prohibit banks from affiliating with entities that are merely "engaged principally" in those same activities.

Further, the Supreme Court observed that "[i]n both the Glass-Steagall Act itself and in the Bank Holding Company Act, Congress indicated that a bank affiliate may engage in activities that would be impermissible for the bank itself." *ICI*, 450 U.S. at 64. Similarly, in *Schwab* the Court commented that "the fact that § 16 of the Glass-Steagall Act allows banks to engage directly in [a service] suggests that the activity was not the sort that concerned Congress in its effort to secure the Nation's banks from the risks of the securities market." 468 U.S. at 221. The same principle necessarily applies here. As we recently stated, "the latitude the Act grants bank holding companies partially to engage in activities such as underwriting, which implicate the Act's policies whether conducted by banks or by bank holding companies, suggests that bank holding companies can, under the Act, be allowed principally to engage in activities which pose the dangers the Act addressed only when conducted by banks." *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 716 F.2d 92, 100 (2d Cir. 1983), *aff'd*, *Schwab*, 468 U.S. 207 (1984). Because underwriting and dealing in government securities pose no hazards to banks themselves, *a fortiori* bank affiliates should be able principally to engage in the same activity.

In sum, the Board's construction of Glass-Steagall is not only reasonable, but dictated by a thorough examination of the legislative history of Glass-Steagall and of the hazards that Congress sought to prevent when enacting § 20. We hold that it was not Congress' purpose in § 20 to preclude a bank affiliate from engaging in the same activities to the same extent as a member bank and we uphold the Board's determination that the reference in

§ 20 to "securities" does not encompass those securities which § 16 allows banks themselves to underwrite.

III "*Engaged Principally*"

We now turn to the Board's determination of when a security affiliate is "engaged principally" in activities covered by § 20. In their applications the bank holding companies sought to comply with the "engaged principally" standard of § 20 by proposing limitations on their underwriting and dealing in bank-ineligible securities. J.P. Morgan & Co., for example, proposed that its bank-ineligible securities activities would not exceed during any rolling two-year period 15 percent of its total business. J.P. Morgan & Co. Proposal, 50 Fed. Reg. 41,025 (1985). It proposed a combination of accounting tests to measure its compliance with the 15 percent limitation.[6] The other companies proposed total volume limits of ten to 15 percent of their total business.

The Board rejected these proposals. Following the analysis set forth in its *Bankers Trust* order, 73 Fed.

6 The limitation would be met if two of the following three tests were satisfied:

(1) The dollar volume of underwriting commitments [or underwriting sales if larger] and dealer sales attributable to ineligible securities activities with the total dollar volume of all of JPMS's activities;

(2) The average assets acquired in connection with ineligible securities activities with the average assets acquired in connection with all of JPMS's activities; and

(3) The gross income [i.e., income before expenses and taxes] from ineligible securities activities with the gross income from all of JPMS's activities.

50 Fed. Reg. 41,025 (1985). "JPMS" is a wholly-owned subsidiary of J.P. Morgan Securities Holdings Inc., which is itself wholly-owned by J.P. Morgan & Co. Inc.

Reserve Bull. 138 (1987), the Board concluded that "engaged principally" in § 20 denotes any "substantial" bank-ineligible activity. *See* 73 Fed. Reserve Bull. at 482. Measured quantitatively, the Board stated that an affiliate would not be principally or substantially engaged in bank-ineligible activities if: (1) the gross revenue from § 20 activities did not exceed five to ten percent of the affiliate's total gross revenues (gross revenue limitation or gross revenue test); and (2) the affiliate's activities in connection with *each* particular type of ineligible security did not account for more than five to ten percent of the total amount of that type of security underwritten domestically by all firms (or, with commercial paper, the average amount of dealer-placed commercial paper outstanding) during the previous calendar year (market share limitation or market share test).[7] Applying this measure to the applications before it, the Board selected the lower five percent figure for both gross revenue and market share limitations. It recognized that this was a "conservative approach," but stated that it would review the limitations within one year of the implementation of its orders. 73 Fed. Reserve Bull. at 485.

The bank holding companies petition for review of this interpretation of "engaged principally." First, they argue that the Board's view contravenes Supreme Court precedent. Second, they contend that the limitation is inconsistent with the language, structure, and legislative intent of

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[7] The Board was unpersuaded, as we are, that § 20 permits two or more affiliates to combine their total gross incomes for purposes of determining whether or not the affiliates are "engaged principally" in ineligible activity. 73 Fed. Reserve Bull. at 486 n.45. The reason is plain. The provisions of § 20 apply to each individual company affiliated with a member bank.

the Glass-Steagall Act. Finally, cross-petitioner Security Pacific Corporation argues that the Board erred in adopting an inflexible percentage test instead of approaching each affiliate's application on a case-by-case basis.

The term "engaged principally" is intrinsically ambiguous. As discussed above, we must uphold the Board's interpretation if it is reasonable. Unlike the facts presented on the issue of the scope of § 20, the Board's position here does not contradict its prior interpretations. Accordingly, we defer to the Board's construction of § 20.

A. *Agnew*

The Board found that "principally" in § 20 means "substantially." The banks urge that in *Board of Governors of the Fed. Reserve Sys. v. Agnew*, 329 U.S. 441 (1947), the Supreme Court decided that "principally" means something more than substantially, and therefore that the Board's decision conflicts with *Agnew*.

In *Agnew* the Board issued an order that required the removal of directors of a national bank because of their affiliation with a company which, in the Board's view, was "primarily engaged" in underwriting securities as prohibited by § 32 of the Act. The United States Court of Appeals for the District of Columbia reversed the Board and held that a company is not "primarily engaged" in underwriting unless the activity is its chief or principal activity—one exceeding 50 percent of the company's business. *See Agnew*, 153 F.2d 785, 790-91 (D.C. Cir. 1946). The Court of Appeals rejected the Board's argument that "primarily" in § 32 could mean "substantially" or "importantly."

The Supreme Court reversed, holding that "primarily" in § 32 meant "substantially." 329 U.S. at 446. In support of that conclusion, the Court noted that Congress used three different terms in the Glass-Steagall Act to describe underwriting firms: (1) those merely "*engaged*" in underwriting (§ 21); (2) those "*primarily engaged*" in underwriting (§ 32); and (3) those "*engaged principally*" in underwriting (§ 20). 329 U.S. at 448. It then concluded that "[t]he inference seems reasonable to us that Congress by the words it chose marked a distinction which we should not obliterate by reading 'primarily' to mean 'principally'." *Id.* Because the Board has found that a gross income level of ten percent of covered activities will trigger § 32, *see* Staff Opinion 3-939, 1 Fed. Reserve Reg. Serv. 389 (Dec. 14, 1981), the holding companies argue that "principally" under § 20 mandates approval of a higher level of activity, and that their proposed ten to 15 percent limitations were well within that level.

The statements in *Agnew* regarding the meaning of "principally" are not dispositive in the instant case. For one thing the meaning of § 20 was not before the Supreme Court in that case. *See Cohens v. Virginia*, 19 U.S. (6 Wheat.) 264, 398 (1821). Further, the statements concerning § 20 are not essential to its holding that "primarily" means "substantially." *See Kastigar v. United States*, 406 U.S. 441, 454-55 (1972). The main focus of the Court's analysis is on definitions of "primary," *see* 329 U.S. at 446, and on the perils Congress sought to check by enacting § 32, *id.* at 447. In fact, the brief discussion of § 20 is used to demonstrate that "[t]here is other intrinsic evidence in the Banking Act of 1933 to support our conclusion [on the meaning of "primary"]." *Id.*

Hence, we read *Agnew* as holding only that "primarily engaged" in § 32 means any "substantial activity."

B. "*Substantially*"

The Board's construction of "engaged principally" as denoting any substantial activity is reasonable. We do not conclude that because "engaged principally" in § 20 and "primarily engaged" in § 32 both denote "substantial activity" that the two terms are therefore synonymous. Substantiality is an amorphous qualitative concept that has many quantitative definitional manifestations, *see The Shorter Oxford English Dictionary* 2172 (3d ed. 1973), which vary with the context in which the term is used. Hence, the *Agnew* dicta that "engaged principally" and "primarily engaged" do not necessarily mean the same thing, *see* 329 U.S. at 448-49, is not entirely circumscribed by the Board's interpretation. In fact, the same considerations that compelled the Court in *Agnew* to conclude that "primarily" in § 32 means "substantially" apply equally—if not more forcefully—here.

The Supreme Court in *Agnew* rejected a reading that "primarily" meant "chief" or "leading" because the concerns that Congress addressed in enacting § 32 do not vanish if the firm's underwriting activities are 49 percent rather than 51 percent. *See* 329 U.S. at 447. In both situations, "a bank director interested in the underwriting business may use his influence in the bank to involve it or its customers in securities which his underwriting house has in its portfolio or has committed itself to take." *Id.* The banks' argument essentially adopts the Court of Appeals holding in *Agnew*, that is, "principally" means "chief" or "first." But the same reasoning that guided the Supreme Court guides us. The worries envisioned by

bank affiliation with securities firms do not disappear simply because the activity is less than 50 percent of a firm's business.

An example illuminates how equating "principally" in § 20 with "chief" or "first" begets the dangers foreseen by Congress. Such an interpretation would allow a member bank to become affiliated with any large integrated securities firm. One commentator has pointed out that reading "principally" as "chief" would allow a bank to be affiliated with Merrill Lynch & Co., Inc., one of the nation's largest investment bankers. *See* Plotkin, *What Meaning Does Glass-Steagall Have for Today's Financial World?*, 95 Banking L.J. 404, 414-16 (1977). It cannot be supposed that the Congress that enacted Glass-Steagall would have intended that § 20 not prohibit such affiliations. This is not to say that "principally" cannot in some contexts mean "chief" or "first," but rather that in § 20 the term must be given a definition that is both sensible *and* in harmony with legislative purpose.

Moreover, the logic of the holding companies' position is that "principally" in § 20 is a directly quantitative, not a qualitative, term. "Substantially," on the other hand, reflects the qualitative aspects of "principally." When Congress wanted to use a quantitative test in the Banking Act of 1933, it knew how to do it. *See* § 2(b), (c), 48 Stat. at 162-63 (definition of affiliate); § 13, 48 Stat. at 183 (collateral requirements for loans to affiliates); § 16 (Seventh), 48 Stat. at 185 (limitations on banks' purchase of securities for own account), § 19(b), 48 Stat. at 187 (level of assets for holding company affiliates to be maintained free of any liens); § 19(c), 48 Stat. at 187 (shareholders' liability determination). Because in § 20 Congress departed from a quantitative approach, the argument that a

qualitative test should be controlling is all the more compelling.

SIA and ICI advance several arguments against the Board's interpretation of "principally." They assert that "engaged principally" in § 20 at least covers any firm "formed for the purpose of" underwriting securities, relying on the Supreme Court's statement in *ICI* regarding repealed § 19(e) that "[a]ll companies formed for the purpose of issuing or underwriting securities would surely meet the 'engaged principally' test." 450 U.S. at 70 n.43. Concededly, the subsidiaries here were formed for the purpose of engaging in securities activities.

Yet, this argument is unpersuasive too. The Court's statement in *ICI* is dicta and seems to indicate nothing more remarkable than that a company formed for the purpose of underwriting securities most likely would be expected to be engaged principally in that activity. Further, since § 20 does not restrict bank-eligible securities activities, SIA and ICI arguably miss the point. Companies formed for the purpose of dealing in bank-eligible securities would not fall within the prohibitions of § 20.[8]

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8 SIA and ICI point to testimony that at least one affiliate was formed for the purpose of dealing in *bank-ineligible* securities. The President of J.P. Morgan & Co. said during the Board hearing that the holding company established its bank-eligible securities subsidiary because it thought that there might be changes in the law allowing dealing in a wider range of securities and that they wanted to have a subsidiary in place when those changes came about. Because we hold that § 20 allows affiliates to engage to a greater extent in securities than the banks themselves, *any* formation of an affiliate would likely have in part a purpose to engage in those activities prohibited to banks. SIA's argument therefore is also a back-door attempt to have us broaden the scope of § 20 to include bank-ineligible securities, an argument we have rejected.

To support their argument, SIA and ICI also rely on former § 19(e) of the Glass-Steagall Act. Section 19(e)—repealed in 1966—indirectly limited bank holding companies' acquisition of subsidiaries "formed for the purpose of, or engaged principally in" prohibited securities activities. 48 Stat. at 188; *see also supra* note 4. Because § 20 and § 19(e) were intended to accomplish the same result, SIA and ICI argue that we should read the two sections as being coextensive.

Even assuming that SIA and ICI are correct, § 19(e) would not have prohibited the activities here approved. It originally was intended to apply to "any affiliate formed for the purpose of, or *engaged* in" securities activities. *See 1932 Hearings*, *supra*, at 13 (text of proposed § 20(e)) (emphasis added). As originally conceived, *any* securities activity was prohibited under § 19(e). Thus, there are only two situations when the term "formed for the purpose of" had any meaning independent from "engaged in": when a company had been formed for the purpose of *engaging* in unpermitted activities, but had (1) not yet commenced activities, or (2) ceased the activities, but might possibly resume them. Plainly, the evil that the "formed for the purpose of" standard was designed to avoid was the formation of subsidiaries ready to "engage"—but not yet engaged—in unauthorized securities activities.

Congress eventually added the term "principally" to "engaged" in § 19(e), presumably to have § 19(e) correspond with the standard laid down in § 20. We think that the original meaning of the "formed for the purpose of" language in § 19(e) was retained after this amendment to qualify the new and less restrictive standard of "engaged principally." Thus, § 19(e) prevented subsidiaries from

either engaging principally in banned activities—which we have held above to be only bank-ineligible activities—*or* being formed for the purpose of engaging principally in such activities. Even if the proscriptions of § 20 are coextensive with those of former § 19(e), none of the subsidiaries here has been formed for the purpose of engaging *principally* in bank-ineligible activities. Section 19(e) therefore would not apply.

Alternatively, SIA claims that Congress intended that § 20 bar underwriting or dealing activities that constitute a "regular" or "integral" part of the affiliate's business, as opposed to "incidental" or "occasional" activities. The activities that concerned Congress did not necessarily arise only with the frequency of their repetition. In any event, the Board's interpretation of "principally" as any "substantial" activity adequately addresses any apprehension arising from the frequency or integral nature of an activity.

The final argument raised by SIA is that because the Board's interpretation of "engaged principally" necessitates regulation, it *a fortiori* contravenes the Glass-Steagall Act. It is true that "Congress rejected a regulatory approach when it drafted the statute." *Bankers Trust I*, 468 U.S. at 153. The Board's interpretation is one that attempts to walk the line that Congress laid down. The mere necessity of "regulation" in carrying out Glass-Steagall's "prohibitions" is insufficient to justify rejection of an otherwise reasonable interpretation of the Act. *Cf. Bankers Trust II*, 807 F.2d at 1067 ("The Glass-Steagall Act does impose a system of flat 'prohibitions' and 'prophylactic' measures, but this cannot obviate the need to examine particular factual situations to determine on which side of the prohibitory line they fall.").

Consequently, the Board's view of "engaged principally" as meaning any substantial activity is reasonable and consistent with Congressional purpose.

C. *Gross Revenue Limitation*

The Board determined that substantial activity, measured quantitatively, constituted five to ten percent of an affiliate's gross revenues over a two-year period. 73 Fed. Reserve Bull. at 485. It set the approved level of activity at the five percent end of this range, but stated its intent to review this level within a year after the order's effective date. *Id.*

One troublesome facet of the Board's ruling is that "engaged principally" in § 20 is equally restrictive as—if not *more* restrictive than—"primarily engaged" in § 32. The Board has stated that if a firm's prohibited activities constitute less than ten percent of its gross business, *see* Staff Opinion 3-939, 1 Fed. Reserve Reg. Serv. 389 (Dec. 14, 1981), or amount to less than ten million dollars regardless of the percentage figure, *see* Board Letter 3-896, 1 Fed. Reserve Reg. Serv. 367 (May 22, 1959), the firm is not "primarily engaged" in such activities under § 32. By placing the permissible level of § 20 activity currently at only five percent of gross revenues—and never more than ten percent—the Board is employing, at least for the present, a more restrictive gross revenue test for § 20 than for § 32.

This initially seems to contradict the Supreme Court's indication that §§ 32 and 20 should be interpreted consistently. *See Schwab*, 468 U.S. at 219 (the term "public sale" should be interpreted consistently because "§§ 32 and 20 contain identical language, were enacted for similar purposes, and are part of the same statute."). But with

regard to "engaged principally" versus "primarily engaged," §§ 20 and 32 differ; accordingly, there is justification for interpreting them slightly differently.

The legislative history also supports the conclusion that the Board's stringent quantitative interpretation of § 20 is reasonable. What became § 20 was proposed by Eugene Meyer, a governor of the Federal Reserve Board, as a *substitute* for the section which eventually became § 32, *see 1932 Hearings, supra*, at 387-88, because he believed that the language in the predecessor to § 32—in relevant respects identical to § 32—was overbroad and that it would therefore be ineffectual. *See id.* at 387. Meyer commented on the "difficulties in the way of accomplishing a complete divorce of member banks from their affiliates arising from the fact that a law intended for that purpose is likely to be susceptible of evasion or else to apply to many cases to which it is not intended to apply," *id.* at 388, and tentatively suggested substituting what is now § 20 for what is now § 32. It defies logic that § 20 should be interpreted *less* restrictively than § 32, based on Meyer's comments that § 20 was intended to be *more* restrictive than § 32.

Further support for a stricter interpretation of § 20 than of § 32 is derived from the fact that the dangers resulting from affiliation are arguably greater than those resulting only from personnel interlocks. The public associates a member bank and its affiliate because of their common ownership and often similar names. The potential for the public to associate the misfortunes of the affiliate with the bank is far greater than the association of firms with personnel interlocks, which are generally unknown to the public.

Given these considerations, we defer to the Board's determination that § 20 allows an affiliate to engage in bank-ineligible securities activities so long as those activities do not exceed five to ten percent of the affiliate's gross revenue. This range is both reasonable and consistent with the statute. Because of the Board's expertise we also defer to its decision to set the gross revenue limitation at five percent.

D. *Market Share Limitation*

The Board's second limitation on the subsidiaries' bank-ineligible securities activities provides that the subsidiaries' involvement in *each* activity may not exceed a five percent share of the total market for that activity. It reasoned that it has employed a market share limitation in determining whether a firm is "primarily engaged" in securities activities within the meaning of § 32. 73 Fed. Reserve Bull. at 484. The Board stated that "the fact that an affiliate would be a major force in a particular securities market would be an evidentiary factor suggesting that the affiliate is 'engaged principally' in underwriting securities." *Id.* It also concluded that a sales volume test—currently employed under its interpretation of § 32—would be subject to manipulation and that a market share test "would provide a useful and objective proxy for sales volume." *Id.* It was concerned that sales volume could be easily inflated by use of repurchase and reverse repurchase agreements for government securities—a common practice among government securities dealers—or by "churning." *Id.*

The bank holding companies argue that neither § 20 nor the legislative history of the Glass-Steagall Act provides a basis for the Board's market share test. They

assert that § 20 mandates an inquiry only into activities *within* a subsidiary rather than one into the size of the subsidiary's activity in relation to the market as a whole. A market share test, they claim, is intended *sub silentio* to promote competition rather than to protect against the hazards of affiliation envisioned by Congress.

The Board's justifications for imposing a market share limitation are not persuasive. It cites only two instances in which it has relied on market share data under § 32. One citation is to a 1947 internal letter from the Board to the Federal Reserve Bank of New York. The second citation is to a 1948 letter now included in a compilation of Board interpretations of Regulation R. *See* Fed. Reserve Reg. Serv. ¶ 3-895 (1948). The 1948 interpretative letter apparently was intended as a guide for future decisions.

It is true that § 32 implicitly delegates to the Board the power to determine when a firm is "primarily engaged" in securities activities, in the same way that § 20 implicitly delegates the power to determine when a firm is "engaged principally" in securities activities. Yet Congress chose to grant the Board power to exempt individuals from § 32, but did not grant it similar power in § 20. Since Congress expressly granted the Board different regulatory power in § 32 than in § 20, it does not at all follow that the Board's power to define the meaning of § 20 is coextensive with its power under § 32. Thus, the Board's reliance on § 32 is not dispositive.

We discern no support in § 20 for the Board's market share limitation. In the legislative history there is evidence that before the enactment of Glass-Steagall, banks and bank affiliates had acquired an increasingly large share of securities activity in relation to investment banks. *See* W. Peach, *The Security Affiliates of National Banks* 108-10

(1941). For example, between 1927 and 1930 the percentage share of commercial banks in origination of bond issues more than doubled. *Id.* at 109. This increasing market share of commercial banks in traditional investment banking activities was not unknown to Congress. *See 1931 Hearings*, *supra*, at 299 (testimony of C.E. Mitchell, Chairman, National City Bank of New York) (presenting data). But, the fact that this was brought to Congress's attention and that Congress did not directly address it is, if anything, a strong indication that Congress was not concerned about market share. Rather, by using the term "engaged principally," Congress indicated that its principal anxiety was over the perceived risk to bank solvency resulting from their over-involvement in securities activity. A market share limitation simply does not further reduce this congressional worry.

In addition, the Board has not proven on the record before us that a market share limitation is an objective proxy for a sales volume test. The Board makes no claim that the Act empowers it to limit the power of bank affiliates to compete in the securities markets open to them. Consequently, the banks' cross-petition to eliminate the market share limitation is granted.

E. *Security Pacific's Claims*

Security Pacific proposed in its application that its subsidiary engage in bank-ineligible securities activities constituting up to 15 percent of the subsidiary's gross revenues. The Board approved a lower level of up to five percent of gross revenues, consistent with its orders approving the other subsidiaries' activities. Security Pacific argues that the Board abused its discretion in setting the lower limitation and by failing to adopt a case-by-case

approach to determining appropriate levels of § 20 activity.

The gravamen of Security Pacific's argument is that its subsidiary should not be equated with the other bank holding company subsidiaries, all of which are based in New York. Security Pacific is located in California. The New York subsidiaries, Security Pacific argues, will be able to engage in a higher level of *bank-eligible* activities and, consequently, a higher level of *bank-ineligible* activities, since bank-ineligible activity levels correspond directly with the total securities activity of the subsidiary. Security Pacific claims that this mandates allowing a higher level of activity for its subsidiary.

We disagree. Section 20 must be read to set down at some point a hard and fast limit on the amount of bank-ineligible securities activity, and we have determined that the Board's limit of five to ten percent of the gross revenue is reasonable. Beyond this limit, there is no room for adjustment in order to ameliorate competitive inequality.

Within the range set by the Board there is, of course, leeway for adjustments that reflect the competitive positions of certain subsidiaries. Security Pacific declined to submit evidence of special circumstances that might distinguish it from the other affiliates involved and warrant approval of a level of bank-ineligible activity greater than five percent. Given this failure, the Board's approval of a five percent level for Security Pacific was not an abuse of its discretion.

Security Pacific also argues that the Board's limitations are inconsistent with Board precedent holding that quantitative measures should be determined on a case-by-case

basis. As noted above, § 20 sets down a line that cannot be crossed no matter how exceptional the circumstances, and it cannot be drawn differently in each case.

CONCLUSION

In sum § 20 of the Glass-Steagall Act forbids member bank affiliation with firms that are "engaged principally" in underwriting or dealing in "securities." It was not Congress' plan to forbid affiliates from those activities that banks themselves could engage in without limitation. The Board's interpretation of § 20 under which government securities—those that banks may without limitation underwrite and deal in—are excluded from the prohibition contained in § 20 is therefore consistent with the Congressional scheme. The Board's qualitative and quantitative constructions of the term "engaged principally" are reasonable, with the exception of the market share limitation. Accordingly, we deny the petitions and cross-petitions for review except with respect to the market share limitation.

Petitions and cross-petitions for review are denied save for the cross-petition for review that seeks to eliminate the market share limitation, which cross-petition is granted.

APPENDIX B

Citicorp
New York, New York

J.P. Morgan & Co. Incorporated
New York, New York

Bankers Trust New York Corporation
New York, New York

Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities

Citicorp, J.P. Morgan & Co. Incorporated, and Bankers Trust New York Corporation, New York, New York (collectively "Applicants"), bank holding companies within the meaning of the Bank Holding Company Act ("BHC Act"), have each applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y, 12 C.F.R. § 225.21(a), to engage through wholly owned subsidiaries, Citicorp Securities, Inc. ("CSI"), J.P. Morgan Securities Inc. ("JPMS"), J.P. Morgan Municipal Finance Inc. ("JPMMF"), and BT Securities Corporation ("BTSC"), respectively, in underwriting and dealing in, on a limited basis, certain securities that member banks may not underwrite and deal in, specifically:

(1) municipal revenue bonds, including so-called "public ownership" industrial development bonds;[1]

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1 The industrial development bonds covered by the applications are only those tax exempt bonds in which the governmental issuer, or the governmental unit on behalf of which the bonds are issued, is the owner for federal income tax purposes of the financed facility (such as airports, mass commuting facilities and water pollution control facilities).

(2) mortgage-related securities (obligations secured by or representing an interest in residential real estate);

(3) consumer-receivable-related securities ("CRRs") (obligations secured by or representing an interest in loans or receivables of a type generally made to or due from consumers); and

(4) commercial paper.[2]

These securities (hereinafter "ineligible securities") may be held by member banks for investment purposes under section 16 of the Banking Act of 1933 (the "Glass-Steagall Act") (12 U.S.C. § 24, Seventh), but may not under that section be underwritten or dealt in by member banks.

Applicants have previously received Board approval under section 4(c)(8) of the BHC Act for the above-mentioned subsidiaries (collectively the "underwriting subsidiaries") to underwrite and deal in U.S. government and agency and state and municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Glass-Steagall Act (hereinafter "eligible securities").[3] These eligible securities include certain municipal revenue bonds (issued for certain housing, university or dormitory purposes) as well as mortgage-related securities issued or sold by certain agencies of the federal government. The proposed new underwriting and dealing activities would be provided in addition to the previously approved activities, with the subsidiaries serving customers

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2 J.P. Morgan has not proposed to underwrite and deal in CRRs. Citicorp's present application does not cover commercial paper, although it has filed a separate application with the Board to underwrite commercial paper.

3 These activities are authorized for bank holding companies under section 225.25(b)(16) of Regulation Y. 12 C.F.R. § 225.25(b)(16). In general, member banks may underwrite and deal in obligations of the United States, general obligations of states and political subdivisions, and certain securities issued or guaranteed by government agencies. 12 U.S.C. §§ 24 Seventh, and 335.

through offices in New York and, in the case of Citicorp, in several other cities in the United States.[4]

Citicorp, with total consolidated assets of $196 billion, is the largest banking organization in the nation.[5] It operates eight banking subsidiaries and engages directly and through subsidiaries in a broad range of permissible nonbanking activities. J.P. Morgan & Co. Incorporated, with total consolidated assets of $76 billion, is the fourth largest banking organization in the nation. It operates two subsidiary banks and engages directly and through subsidiaries in a variety of permissible nonbanking activities. Bankers Trust New York Corporation, with total consolidated assets of $56.4 billion, is the eighth largest banking organization in the nation. It also operates two subsidiary banks and engages directly and through subsidiaries in a variety of nonbanking activities.

Notice of the applications, affording interested persons an opportunity to submit comments on the proposals, has been published (50 *Federal Register* 20,847 and 41,025 (1985) and 51 *Federal Register* 16,590 (1986)). In addition, on December 31, 1986, the Board announced that it would hold a public hearing on February 3, 1987, on the applications, and requested specific comment on certain major issues, including a framework of prudential limitations to address the potential for conflicts of interest, unsound banking practices and other adverse effects raised by the proposals.

Four commenters, including the Securities Industry Association ("SIA"), a trade association of the investment banking industry, and the Investment Company Institute ("ICI"), a trade association of the mutual fund industry, opposed one or more of the proposals (collectively the "protestants"). The majority of the written comments were from banking organizations and trade associations representing segments of the banking industry and were in favor of the proposals. The Antitrust Division

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4 For purposes of the Order, in accordance with common industry usage, the term dealing refers to the business activity of holding oneself out to the public as being willing to buy and sell securities as principal in the secondary market.

5 All asset data are as of December 31, 1986.

of the U.S. Department of Justice and the U.S. Treasury Department also supported approval of the proposals.

Because each of the underwriting subsidiaries that propose to underwrite and deal in the ineligible securities would be affiliated through common ownership with a member bank, the Board must determine whether, upon consummation, the subsidiaries would be "engaged principally" in underwriting or the public sale of securities within the meaning of section 20 of the Glass-Steagall Act.[6] If so, the Board may not approve the applications.[7] In addition, the Board must determine whether the proposed activities are so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)) and are, on this basis, activities in which bank holding companies may engage.

In two previous decisions, the Board considered some of the issues that are raised in the applications now before the Board. On December 24, 1986, the Board approved the application of

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6 Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) provides that:

> ". . . no member bank shall be affiliated . . . with any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities . . . ."

Because Applicants propose that certain of their officers and directors will also be officers and directors of the underwriting subsidiaries, the proposal raises an issue under section 32 of the Glass-Steagall Act (12 U.S.C. § (78) which provides that:

> No officer, director, or employee of any corporation . . . primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities shall serve [at] the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.

7 *See Securities Industry Association* v. *Board of Governors of the Federal Reserve System*, 468 U.S. 207, 216 (1984) (hereinafter "Schwab").

Bankers Trust New York Corporation ("*Bankers Trust*") to engage in the placement of commercial paper issued by third parties as one activity of a commercial lending affiliate.[8] In that decision, the Board concluded that the placement activity involved did not constitute underwriting, distributing, or the public sale of securities for purposes of section 20. The Board further concluded that, even assuming this activity is covered by section 20, the term "engaged principally" in section 20 of the Glass-Steagall Act would allow the activity in an affiliate of a member bank if it is relatively insubstantial in terms of the total activity of the affiliate and the size of the market. Specifically, the Board cited the fact that since the gross revenues generated by the commercial paper activities of the affiliate would be no more than 5 percent of the affiliate's total gross revenues and that the affiliate's share of the total market for dealer placed commercial paper would not exceed 5 percent, the proposal would not violate section 20. In addition, the Board established a number of conditions to assure that the conduct of the activity was consistent with safe and sound banking practices and avoided conflicts of interest, concentration of resources, and other adverse effects. The Board applied this same framework of analysis in approving, on March 18, 1987, an application by The Chase Manhattan Corporation ("Chase") to engage in underwriting and dealing in commercial paper in a commercial finance subsidiary of the parent bank holding company.[9] The Board has been guided by these two decisions in deciding the applications now before the Board.

An index to this decision is contained in Appendix A to this Order.

Part I. Introduction & Summary of Findings

These applications raise fundamental questions concerning the scope of the Glass-Steagall Act's restrictions on the securities activities of member bank affiliates. Their resolution re-

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8 73 FEDERAL RESERVE BULLETIN 138 (1987).

9 The Chase Manhattan Corporation, 73 Federal Reserve Bulletin 367 (Order dated March 18, 1987).

quires application of a statute adopted over 50 years ago in very different circumstances to a financial services marketplace that technology and other competitive forces have altered in a manner and to an extent never envisioned by the enacting Congress. Applicants' member bank affiliates seek to activate until now dormant provisions in section 20 of the Glass-Steagall Act to participate in underwriting and dealing in certain securities, so long as they are not engaged principally in this activity.

In its evaluation of the issues raised by the applications, the Board has been guided, as it must, by the terms of the statute and the underlying Congressional intent and purposes of the Act as evident in its structure and legislative history. Thus, the Board fully recognizes that Congress, through the Glass-Steagall Act, intended to separate commercial banks from general securities underwriting firms. Both the Board and the federal courts have often articulated the potential dangers to commercial banks from general underwriting activities that motivated the Congress in enacting the Glass-Steagall Act. The Board remains fully sensitive to these concerns.

Nevertheless, despite these dangers, the Congress drew a clear distinction between member banks and their affiliates in the Glass-Steagall Act. Except for certain specifically enumerated securities, including government securities, member banks were prohibited under the Glass-Steagall Act from engaging in any underwriting whatsoever. Member bank affiliates, on the other hand, were given a different statutory treatment under section 20 of the Act.

Member bank affiliates are permitted to participate in otherwise impermissible securities underwriting so long as they are not "engaged principally" in this activity. While prior to this time, there apparently has been no incentive to test the meaning of this authorization, the Board is now asked to apply it to specific proposals to engage in certain underwriting activities. Thus, the Board's task is to apply this explicit Congressional authorization to the proposed activities, but in a manner that gives effect to the Congressional intent in adopting the Glass-Steagall Act. Because of the precedent-setting nature of these applications, the Board has given them careful attention, ex-

tending over a period in excess of a year, during which time the statutory language, the legislative history, and the implications of these proposals for banking organizations and the financial markets generally have been carefully analyzed by the Board on a number of occasions. In addition, the Board conducted a hearing before the Board members on these important issues.

For the reasons set out in its decisions in the *Bankers Trust* and *Chase* cases, the Board believes it is bound by the statutory language of section 20 to conclude that a member bank affiliate may underwrite and deal in the ineligible securities proposed in the applications, provided that this line of business does not constitute a principal or substantial activity for the affiliate. The Board reaffirms its conclusion in those cases that Congress intended that the "engaged principally" standard permit a level of otherwise impermissible underwriting activity in an affiliate that would not be quantitatively so substantial as to present a danger to affiliated banks. The Board believes that it is only on this basis—that the activity would be insubstantial—that Congress concluded that, despite the hazards from underwriting that caused it to ban banks from engaging in underwriting, this activity would be permissible for the affiliates of member banks.

The Board devoted a considerable effort to evaluation of the factors that should be used to determine the level of ineligible underwriting and dealing activity that would not exceed the substantiality threshold. Taking into account its precedent in the administration of the Glass-Steagall Act and the comments at the hearing on this issue, the Board again concluded that the principal factors that should be included in this judgment are gross revenue and market share. As explained in detail below, the Board believes that these factors are not susceptible to manipulation to increase artificially levels of activity and fairly reflect the amount of involvement of a bank affiliate in securities underwriting.

With respect to the appropriate quantitative level of ineligible activity permitted under section 20, the Board concludes that a member bank affiliate would not be substantially engaged in underwriting or dealing in ineligible securities if its gross reve-

nue from that activity does not exceed a range of between five to ten percent of its total gross revenues. The Board also believes that a similar range should apply to the market share test it believes is appropriate under section 20. This range was established by reference to the Board's interpretations of the "primarily engaged" standard in section 32 of the Glass-Steagall Act. As discussed below, under these interpretations, a company would not generally be considered engaged substantially in ineligible securities activity if its gross revenues from that activity did not exceed 5 percent of its total gross revenues. Where underwriting volume was not large in absolute terms, however, somewhat higher levels of revenue were permitted, but generally not greater than 10 percent of total gross revenues.

Applying this framework to the current applications, the Board came to the conclusion that, in view of the fact that the volume of ineligible securities activity projected by Applicants would be very large in absolute terms, the lower end of the permissible range, 5 percent, should determine whether Applicants' gross income or market share from ineligible activity would be substantial. The Board recognizes that this 5 percent threshold for measuring the concept of "engaged principally" is a conservative interpretation of the level of activity permitted by section 20. The Board believes that a conservative, step by step approach is merited in applying the provision of a statute that was intended to deal with a crisis in our banking system and that has not been extensively interpreted by the courts as applied to the applications now before the Board. In the light of experience, the Board will consider, not later than one year from the date of this Order, whether, under the framework established by the Board in this Order, somewhat higher levels of activity would be consistent with the Board's finding that underwriting and dealing in ineligible securities in an affiliate of a member bank is permissible so long as the level of this activity measured by gross revenue and market share is not substantial.

In addition, the three applications now before the Board raise an important issue that was not present in the *Bankers Trust* and *Chase* applications. In those two cases, the applicants proposed to place or underwrite commercial paper in a subsidiary

that was not engaged in securities underwriting activities at all. Here, the three Applicants propose to underwrite and deal in securities in a subsidiary that is otherwise engaged in underwriting and dealing in government securities and other securities that banks may underwrite and deal in pursuant to section 16 of the Glass-Steagall Act.

Thus, in the three pending applications the Board must consider whether underwriting U.S. government securities and other securities that a bank may underwrite pursuant to section 16 of the Glass-Steagall Act should be considered a permissible activity for the purposes of applying section 20 of the Glass-Steagall Act to the proposed underwriting subsidiaries. If underwriting these securities, and particularly U.S. government securities, is considered permissible under section 20, as it is under section 16, an affiliate engaged principally in these activities could be then less than principally engaged in underwriting the otherwise impermissible securities proposed in the applications, including commercial paper, mortgage-backed securities and municipal revenue bonds. The answer to this question has vital significance for bank holding companies seeking to underwrite and deal in ineligible securities. Because of the operation of the net capital rules established by the Securities and Exchange Commission for broker-dealers, as a practical matter it is not feasible for bank affiliates to underwrite and deal in ineligible securities, other than commercial paper, within the confines of section 20 unless the subsidiary in which this activity takes place is engaged principally in underwriting and dealing in eligible securities—essentially U.S. government securities.

The question as to whether underwriting and dealing in government securities is included within the prohibition of section 20 of the Glass-Steagall Act depends upon an analysis of the language of the statute, the intention of Congress and the Board's own practice in administering the Act. The Board decided, in December 1986, not to resolve this question until after a hearing had given the parties an opportunity to develop further the record on this matter.

In the light of these considerations, the Board has concluded that U.S. government and other securities specifically made eligible for underwriting and dealing by member banks in section 16 should not be viewed as the kind of activity proscribed by section 20. The Board took into account, first, the fact that the Board has previously decided that a member bank affiliate is not engaged principally in impermissible activities if its sole business is underwriting and dealing in U.S. government and other eligible securities.[10] Second, the Board considered that Congress did not intend to apply a more restrictive underwriting standard to member bank affiliates than it legislated for member banks themselves.

The Board's conclusion with respect to the content and meaning of the authorization of section 20 to member bank affiliates to be less than engaged principally in otherwise impermissible underwriting activities is all the more compelling because the Board has reached the conclusion that the activities proposed in these applications can be conducted by bank affiliates on a safe and sound basis and without undue risk to affiliated banks. On the contrary, the evidence seems to indicate that without this authority banking organizations will be at a disadvantage in the competition to supply the credit needs of the most creditworthy borrowers with access to the less costly commercial paper market, with a consequent continuing decline in the overall quality of bank loan portfolios.

The Board has also evaluated whether the activities proposed in the applications are closely related to banking and a proper incident thereto under section 4(c)(8) of the BHC Act. 12 U.S.C. § 1843(c)(8). As stated in detail below, the Board has concluded that, because of the considerable experience of banks in underwriting and dealing in eligible securities, which are closely analogous to the proposed ineligible securities activities, and because the proposed commercial paper activities are functionally equivalent to traditional commercial banking functions, banking organizations are fully familiar with the proposed activities and have the expertise and capability to

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10 *See* 12 C.F.R. § 225.25(b)(16).

carry out the proposed functions. The Board also concluded that the proposed *de novo* participation in this activity would have the beneficial effect of substantially increasing competition, particularly in the highly concentrated commercial paper market, with the substantial expected public benefits of lowering financing costs as well as providing greater convenience to customers and increased efficiency in the proposed services.

As noted above, Congress recognized that a member bank affiliate that is not engaged principally in underwriting activities covered by section 20 could engage in otherwise impermissible securities underwriting even though it was aware that this activity could give rise to subtle hazards that could impair public confidence in depository institutions. The Board believes Congress was prepared to accept these risks because they could be contained within fully acceptable limits through maintaining the corporate separateness of the underwriting firm and the affiliated bank and through limitations on the relative size of the otherwise impermissible activities to assure their insubstantiality. These prudential limits have been fully implemented in the Board's interpretation of the Glass-Steagall Act.

In addition, other safeguards, both as a practical matter and under other statutory authorities, will be in place. As a practical matter, the securities which the Applicants propose to underwrite and the Board is prepared to authorize are securities that member banks are eligible to purchase for their own account, are of high quality and involve minimum risk. In terms of the statutory framework, the Board notes that bank holding company affiliates that engage in securities underwriting would be subject to SEC jurisdiction under the securities laws. Moreover, although not required by the Glass-Steagall Act, the Board believes it is appropriate to require that member bank affiliates underwriting otherwise impermissible securities observe a number of prudential considerations to assure capital adequacy and to limit both transactions and the flow of information between an underwriting subsidiary and other affiliates of the parent banking organization. These prudential considerations are explained in Part III below.

Accordingly, the Board has concluded that, subject to the limitations established in this Order, approval of each of the three applications would not result in a violation of the Glass-Steagall Act and would be consistent with the closely related and proper incident to banking standards of section 4(c)(8) of the Bank Holding Company Act.

Part II. Glass-Steagall Act

A. Applicants' Contentions

The Applicants contend that the underwriting subsidiaries would not be "engaged principally" in underwriting securities within the meaning of section 20 of the Glass-Steagall Act because the subsidiaries will limit the volume of their ineligible activity to a small percentage of their total business and so that the subsidiaries would not have a significant share of the market for any of the ineligible securities underwritten or dealt in.[11]

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11 Citicorp proposes (in the third year and thereafter) to limit the total sales volume of underwriting by CSI in ineligible municipal revenue bonds, mortgage-related securities and CRRs to no more than 10 percent of all securities (both eligible and ineligible) underwritten by the affiliate during the previous year. Citicorp would similarly limit the affiliate's dealing in ineligible securities to 10 percent of its total securities dealing activity. Citicorp would also restrict the affiliate's underwriting of each type of security to no more than 3 percent of the total amount of each type of ineligible security underwritten domestically during the previous calendar year by all firms (mortgage-related securities and CRRs constitute a single category for this purpose). It would also limit the amount of each type of securities it may hold for dealing so as not to exceed this market cap.

Morgan proposes to limit ineligible underwriting and dealing activity by its affiliates (JPMS and JPMMF) in municipal revenue bonds, mortgage-related securities and commercial paper so that the activity will not, over any two-year period, account for more than 15 percent of the total consolidated eligible and ineligible securities activity of the affiliates as measured by two of the following three criteria: gross income, sales volume and average assets acquired in connection with the activity. Morgan would adopt the same market limitations as Citicorp, except that it proposes a 10 percent market share limitation for com-

The Applicants contend that the term "engaged principally" in section 20 means the chief or single largest activity, and that, therefore, their underwriting subsidiaries may underwrite and deal in ineligible securities so long as this ineligible activity does not constitute more than 50 percent of the subsidiaries' total business activity or represent its single largest business activity.[12] On this basis and subject to the proposed limitations on each subsidiary's ineligible securities underwriting and dealing activity, Applicants contend their underwriting subsidiaries would be "engaged principally" in underwriting and dealing in eligible securities, which is permissible under section 20, and, therefore, the subsidiaries could not by definition be engaged principally in underwriting ineligible securities in violation of section 20 of the Glass-Steagall Act. Applicants further claim that, even under the broadest reading of "principally" as denoting any substantial activity, their subsidiaries would not be engaged principally in ineligible securities activity under the limitations proposed in their applications.

Applicants also argue that the proposed dealing activities are not covered by section 20 of the Glass-Steagall Act, which they claim is limited to activities involving the initial distribution of securities. They base this claim on the fact that section 20 does not refer to "dealing" *per se*, but to the functions of issuance, flotation, underwriting, public sale, or distribution of securities.

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mercial paper based upon the average amount of dealer-placed commercial paper outstanding during the previous four calendar quarters.

Bankers Trust proposes to conduct, through its affiliate BTSC, ineligible underwriting and dealing activity involving municipal revenue bonds, commercial paper, and mortgage- and-consumer-receivable-related securities under the same tests as proposed by Morgan.

12 The Applicants rely on a dictionary definition of the term "principally" to mean the single largest activity and statements in the U.S. Supreme Court decision in *Board of Governors of the Federal Reserve System* v. *Agnew*, 329 U.S. 441, 446, 448 (1947), concerning section 32 of the Glass-Steagall Act, which they argue indicate that "principally" as used in section 20 means more than 50 percent of the company's business.

B. Protestants' Comments

The protestants claim that Applicants' view of the term "principally" would vitiate the central purpose of the Glass-Steagall Act by allowing member banks to reestablish "security affiliates" that could rival the largest investment banking firms. For this reason, the protestants contend that the term "principally" must be interpreted consistent with Congressional intent to denote any substantial, significant, regular or non-incidental activity, whether or not it is the largest activity of the affiliate.

ICI further contends that the "engaged principally" standard of section 20 also would cover any company "formed for the purpose of" underwriting securities of any sort, the description of a securities company that was contained in the now repealed section 19(e) of the Glass-Steagall Act.[13] ICI contends that each of the underwriting subsidiaries was formed for the purpose of underwriting securities and thus, in its view, would be "engaged principally" in underwriting securities under section 20.

The protestants also contend that the terms "stocks, bonds debentures, notes, or other securities" in section 20 include all securities, both eligible and ineligible. Thus, they argue that, even under Applicants' interpretation of "engaged principally," the proposals to conduct ineligible securities activity in a government securities underwriting subsidiary would violate section 20 because the subsidiary's largest activity would be underwriting and dealing in "securities," albeit the preponderance of these securities would be bank-eligible U.S. government, state, and municipal securities.

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13 Banking Act of 1933, Pub. L. No. 66, § 19(e), 48 Stat. 162, 188 (codified at 12 U.S.C. § 61(e) (1964)), *repealed by* Act to Amend the Bank Holding Company Act of 1956, Pub. L. No. 89-485, § 13(c), 80 Stat. 236 (1966).

Section 19(e) prohibited a holding company affiliate, which was defined to include a bank holding company, from voting the shares of its subsidiary member bank if the holding company affiliate controlled, or participated in the management or direction of, any business organization "formed for the purpose of, or engaged principally in, the issue, flotation, underwriting, public sale, or distribution . . . of stocks, bonds, debentures, notes, or other securities of any sort."

Applicants counter that the term "securities" in section 20 does not include government securities and other securities member banks are authorized to underwrite and deal in under section 16, on the theory that a member bank affiliate may engage in any activity authorized for the member bank under the Glass-Steagall Act.

C. Analysis of Glass-Steagall Act Issues

1. Securities that a Member Bank May Underwrite are not Covered by the Prohibition of Section 20.

Protestants contend that the term securities in section 20 encompasses all securities—both ineligible as well as bank eligible securities—and that, therefore, the proposed subsidiaries would be "engaged principally" in underwriting securities for purposes of section 20 even under Applicants' view of the term "principally."

The Board notes that, on its face, section 20 draws no distinction between eligible and ineligible securities, as is the case under other sections of the Glass-Steagall Act. The section simply contains a prohibition on a member bank's affiliation with any corporation engaged principally in underwriting "stocks, bonds, debentures, notes, or other securities."

Looking at the statute as a whole, however, the Board believes that Congress did not intend to include the eligible securities activity authorized for member banks under section 16 of the Glass-Steagall Act within the scope of section 20's prohibition against an affiliate's being engaged principally in the underwriting or public sale of "stocks, bonds, debentures, notes, or other securities." In the Board's view, the structure and Congressional intent of the Glass-Steagall Act make clear that in light of the express authorization in section 16 for member banks to underwrite eligible securities, the limitation of section 20 against a member bank affiliate being engaged principally in underwriting securities does not encompass bank eligible securities. In this regard, the Supreme Court has stated that the structure of the Glass-Steagall Act reveals a Congressional intent to impose a "less stringent standard" on member bank affiliates

under section 20 than is applied to the direct activities of member banks under section 16 of the Act[14] and that under the Glass-Steagall Act "a bank affiliate may engage in activities that would be impermissible for the bank itself."[15]

As section 16 expressly provides, and as was clear prior to its enactment, banks have the power to underwrite and deal in government obligations.[16] Given that section 20 establishes a less rigorous standard for member bank affiliates than is applicable to a member bank, it follows, *a fortiori*, that such bank eligible underwriting and dealing activity is permitted for a member bank affiliate. In reaching this conclusion, the Board has applied a fundamental principle of statutory construction that the various provisions of a statute should be construed as a whole and that a particular section of a statute may not be interpreted in isolation without regard to other sections of the statute of which it is a part.[17]

In accordance with this interpretation, the Board has for some time authorized bank holding companies, including those that controlled member banks, to establish subsidiaries to underwrite and deal in securities that are expressly authorized for member banks to underwrite and deal in under section 16,[18] and in 1984 authorized such activity for bank holding companies

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14 *Board of Governors of the Federal Reserve System* v. *Investment Company Institute*, 450 U.S. 46, 61 n.26 ("*ICI II*").

15 *ICI II*, 450 U.S. at 63-64.

16 2 F. Redlich, *The Molding of American Banking: Men and Ideas* 389 (1951); W. Peach, *The Security Affiliates of National Banks* 43-44 (1941).

17 *See United States* v. *Morton*, 467 U.S. 822, 828, *rehearing denied*, 468 U.S. 1226 (1984); *Philbrook* v. *Glodgett*, 421 U.S. 707, 713 (1975); *United Mine Workers of America* v. *Andrews*, 581 F.2d 888, 892 (D.C. Cir.), *cert. denied*, 439 U.S. 928 (1978). 2A Sutherland Statutory Construction § 46.05 (4th ed. 1984).

18 *United Bancorp*, 64 FEDERAL RESERVE BULLETIN 222 (1978); *Stepp, Inc.*, 64 FEDERAL RESERVE BULLETIN 223 (1978); *United Oklahoma Bankshares, Inc.*, 65 FEDERAL RESERVE BULLETIN 363 (1979); *Citicorp*, 68 FEDERAL RESERVE BULLETIN 249 (1982).

generally by regulation.[19] The Board's decision in these cases was premised upon its view that the conduct of such bank eligible securities activities by member bank affiliates is not the type of activity prohibited by section 20 or 32 of the Glass-Steagall Act.

The interpretation of section 20 urged by protestants that a member bank affiliate may not underwrite securities that are expressly authorized for a member bank itself not only runs counter to the Supreme Court's statements regarding the scope of section 20, but is also inconsistent with the fundamental purpose of the Glass-Steagall Act. The Glass-Steagall Act was enacted with one central purpose in mind, to protect bank depositors from the hazards that Congress viewed as attributable to the combination of commercial and investment banking. However, Congress did not view the traditional underwriting activities of banks in government securities as giving rise to these dangers to the bank and its depositors and on this basis permitted the continuation of that activity within the bank itself.[20]

Section 20 was designed to limit the scope of activities of member bank affiliates as a complement to the restrictions on banks' direct underwriting and dealing activities,[21] and as a means of enforcing the separation of commercial from investment banking.[22] Clearly, therefore, section 20 was not designed to prohibit affiliates from engaging in activity a bank could

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19 12 C.F.R. § 225.25(b)(16). The Board notes that protestants did not challenge the Board's rule authorizing this activity for bank holding companies or any of its approvals for bank holding companies to engage in this activity.

20 *See ICI II*, 450 U.S. at 61-62.

21 The Senate Report on the bill that subsequently became the Glass-Steagall Act indicates that Congress was concerned with the fact that banks had formed affiliates to conduct activity "never contemplated by the National Banking Act." S. Rep. No. 77, 73d Cong., 1st Sess. 10 (1933). *Accord*: 75 Cong. Rec. 9887 (1932) (remarks of Sen. Glass) and 75 Cong. Rec. 9911 (1932) (remarks of Sen. Bulkley). *See also Investment Company Institute* v. *Camp*, 401 U.S. 617, 629 (1971) ("*ICI I*").

22 *See ICI II*, 450 U.S. at 61-62.

lawfully conduct.[23] Moreover, there is some evidence in the legislative history of the Glass-Steagall Act that section 20 was not meant to prohibit the underwriting of government securities. 76 Cong. Rec. 2000, 2274 (1933) (remarks of Sen. Long); 76 Cong. Rec. 1941 (1933) (remarks of Sen. Glass).

To read the statute otherwise would mean that Congress intended to impose a substantially stricter standard on an affiliate than on the member bank itself, an interpretation that would be out of harmony with the central purpose of the Act to protect the bank and its depositors. Moreover, with respect to the analogous question raised in *ICI II*, as to whether an activity could be prohibited under section 21 that was authorized under section 16, the Supreme Court stated that section 21 "surely was not intended to require banks to abandon an accepted banking practice that was subjected to regulation under section 16." 450 U.S. at 63. In affirming the Board's decision authorizing bank holding companies to act as discount brokers, the Court also noted that the fact that section 16 authorizes the activity for member banks suggested that it was not the type of activity at which the Glass-Steagall Act was aimed.[24]

Similarly, the United States Court of Appeals for the D.C. Circuit has recently stated that "those activities of commercial banks that section 16 places on the acceptable commercial banking side of the line [between commercial and investment banking] cannot be placed by section 21 on the impermissible investment banking side of the line."[25] Accordingly, the court concluded that section 21 of the Glass-Steagall Act would not prohibit a bank from selling securities to the extent authorized for member banks under section 16, even before the amendment to section 21 in 1935 excepting from section 21's prohibition activities authorized for member banks under section 16.

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23 *Id.*

24 *Schwab*, 468 U.S. at 221.

25 *Securities Industry Association* v. *Board of Governors of the Federal Reserve System*, 807 F.2d 1052, 1058 (D.C. Cir. 1987), *petition for cert. pending* No. 86-1429 ("*Bankers Trust II*").

The court reached this conclusion on two separate and independent grounds, both of which, in the Board's view, support the conclusion that section 20 does not cover activity authorized under section 16. First, the court noted, as Applicants point out, that the 1935 Amendment to section 21 was termed a clarifying amendment "to make it clear that [section 21] does not prohibit any financial institution or private banker from engaging in the securities business to the limited extent permitted to national banks under [section 16]."[26] This the court felt necessarily implied that the authorization under section 16 also applied to the prohibition of section 21 against selling and underwriting securities generally, even before the 1935 amendment. Second, the court noted that, unless the authorization of section 16 was read as an exception to section 21, a member bank would be prohibited by section 21 from conducting activities the bank was expressly authorized to conduct under section 16, a result the court termed absurd. *Id.* at 1058.

The Board believes this reasoning is directly applicable to section 20, which by its terms covers the same types of securities and the same underwriting and selling activities described in section 21. Thus, in order to avoid the illogic of barring a member bank affiliate from activity expressly authorized for the member bank, the Board believes that section 20 must necessarily not cover securities activity authorized for member banks under section 16.[27] Moreover, given the fact that Congress has

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26 H. Rep. No. 742, 74th Cong., 1st Sess. 16 (1935). Relying on the legislative history, the court in *Bankers Trust II* said the 1935 amendment to section 21 was "simply to leave no doubt of the need to read the two sections [16 and 21] harmoniously. . . ." 807 F.2d at 1058.

27 The SIA claims that an interpretation of section 20 that prohibits a bank affiliate from underwriting and dealing in even eligible securities is not unreasonable because Congress may have intended the underwriting of government securities to be conducted directly by the bank—a federally regulated entity. Such an explanation is implausible, in the Board's view, because when Congress undertook to regulate broker-dealers generally shortly after passage of the Glass-Steagall Act, companies dealing only in government securities were expressly exempted from federal regulation. Thus, any company that underwrote only government securities would not have been subject to federal regulation.

legislated a less stringent standard for member bank affiliates than for banks and that Congress, as the court concludes, did not intend section 21 even before its amendment to bar member banks from activity authorized under section 16, it follows that Congress must necessarily have intended not to bar their affiliates from such activity.[28]

Finally, the Board notes that the limited expansion of the activities of Applicants' government securities subsidiaries, as proposed in the applications and limited by this Order, would not transform these subsidiaries, which would derive substantially all of their income from permissible eligible underwriting activities and would not engage in a full investment banking business, into the type of general securities underwriting affiliates Congress intended to divorce from member banks in 1933.

Since eligible securities cannot reasonably be viewed as securities for purposes of section 20, member bank affiliates that conduct such eligible securities underwriting activity cannot be viewed as engaged in the securities underwriting business proscribed by section 20 and thus may—as may any other member

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28 Protestants contend that the failure of Congress to amend section 20 in 1935 to permit member bank affiliates to underwrite securities authorized under section 16 demonstrates member bank affiliates were not intended to be permitted to conduct such activity. The Board, however, believes that the better view is that articulated in *Bankers Trust II* that the 1935 amendment merely clarified the preexisting state of affairs and that, just as banks were not prohibited by section 21 from engaging in activity permitted under section 16 even before the amendment, member bank affiliates must necessarily not have been prohibited from engaging in such activity under section 20. Thus, Congress' failure to amend section 20 in 1935 does not mean that Congress intended to bar member bank affiliates from activity permitted for member banks. Moreover, it was necessary to clarify section 21 because it is a criminal statute and the Attorney General had expressed the view with respect to certain aspects of section 21 that clarification would be desirable. *Banking Act of 1935: Hearings on S. 1715 and H.R. 7617 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 74th Cong., 1st Sess. 139-140 (1935) (Testimony of J.F.T. O'Connor). Section 20, however, is not a criminal statute and in light of the Board's ability to issue interpretations of that statute, there was no pressing need for clarification, as was the case with section 21.

bank affiliate—engage in ineligible underwriting and dealing activity where such activity is not a principal line of business for the affiliate. In the Board's view, there is no basis in the terms or legislative intent of section 20 to prohibit an eligible securities underwriting subsidiary from underwriting and dealing in any ineligible securities activity while allowing a subsidiary engaged in commercial finance, mortgage banking, securities brokerage or other nonbanking activity permissible for bank holding companies to engage to some extent in ineligible securities activities.

In this regard, the Board has considered the proposed limited expansion of Applicants' government securities subsidiaries' activities in light of the hazards to the bank and its customers that the Glass-Steagall Act is intended to prevent. As noted, Congress clearly did not view the underwriting of bank-eligible securities as harmful to the bank or its depositors and Congress plainly permitted ineligible underwriting activity so long as it did not amount to a principal activity. Moreover, as noted, the Board's order in this case goes further than Congress under the Glass-Steagall Act and establishes limitations on the conduct of the activity under the Bank Holding Company Act to assure that the activity will not produce significant conflicts of interest, unsound banking practices, unfair or decreased competition, undue concentration of resources or other adverse effects.[29]

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29 In its evaluation of this case, the Board has carefully considered the fact that Applicants' underwriting subsidiaries were formed in major part through the transfer to the subsidiaries of government securities activities previously conducted as departments or divisions of the Applicants' member bank subsidiaries. As indicated, the Board has previously approved the transfer of such activities to the holding companies' underwriting subsidiaries as a permissible nonbanking activity under the BHC Act. Accordingly, the Applicants are engaged in this activity pursuant to law and regulatory authorization. While the transfer of these functions could result in the deliberate creation of a large base of eligible activity, the size of the ineligible activity that may be conducted by these affiliates is sharply limited by the "engaged principally" provisions of the Glass-Steagall Act as interpreted by the

For the above reasons, the Board believes that the term "securities" in section 20 must be read as not including those securities that member banks are expressly authorized to underwrite and deal in under section 16.

2. Dealing Constitutes the Underwriting or Public Sale of Securities Under Section 20.

Applicants maintain that "dealing" is not an activity covered by the terms "issue, flotation, underwriting, public sale, or distribution" in section 20, particularly if dealing is limited only to secondary market sales and does not involve an initial distribution of securities. For the reasons set out below and more fully in the attached Appendix B, the Board concludes that the securities activity covered by section 20 is not limited to the initial distribution of securities, but also includes the activity of holding oneself out to the public as being willing to buy and sell securities as a principal in the secondary market, or "dealing" as that term is used by the Applicants. This conclusion is consistent with the literal meaning of the term "public sale" in section 20, the legislative history of the section, judicial interpretation, the purposes of the Act, and the Board's longstanding practice.

Literally, the term "public sale" in section 20 is broad enough to encompass dealing in securities. A dealer commonly refers to a person who holds himself out to the public as being willing to buy and sell securities for its own account. 2 L. Loss, *Securities Regulation* 1215, 1297 (2d ed. 1961). Moreover, the legislative history of the Glass-Steagall Act indicates that Congress intended to cover not only underwriting activity but also stock speculation, market making and participation in trading

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Board. As discussed below, these provisions involve the concept of a quantitative limitation on underwriting activity which is embodied in the income and market share criteria for establishing "substantiality" contained in this Order. The Board wishes to stress that the latter criterion, in particular, creates a limitation on underwriting activity which is independent of the size of the affiliate that might be established by purposeful transfer of activities from the bank to the underwriting affiliate.

pools—activities attributable to dealing and not generally associated with initial distribution activities.[30]

On this basis, the Board for many years has consistently ruled that dealing is covered by section 32 of the Act, which, as noted, is identical to section 20 in terms of its coverage of issuance, flotation, underwriting, public sale, or distribution activities.[31]

The conclusion that dealing constitutes the "public sale" of securities under section 20 is also supported by the Supreme Court's observation in *Schwab*, 468 U.S. at 217-18, that the activities described in section 20 refer, at a minimum, to operations in which the affiliate acts as a principal.

3. The Term "Engaged Principally" in Section 20 Denotes any Substantial Activity.

In its *Bankers Trust* decision, the Board concluded that, even if the placement as agent of commercial paper were deemed to constitute an activity covered by section 20 of the Glass-Steagall Act, Bankers Trust's commercial lending affiliate would not be "engaged principally" in underwriting or dealing in securities within the meaning of section 20 under the 5 percent income and market share limits at issue in that case. The Board held that the term "engaged principally" in section 20 denotes any activity of the underwriting affiliate that is substantial, even if

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30 *See* S. Rep. No. 77, 73d Cong., 1st Sess. 10 (1933). *See also Operation of the National and Federal Reserve Banking Systems, 1931: Hearings on S. Res. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 71st Cong., 3d Sess. 198-199, 306-309, 1063-1064. The conclusion that section 20 covers dealing is also more consistent with the purposes of the Glass-Steagall Act to address the Congress' concern over the "subtle hazards" of a bank having a pecuniary interest in the purchase and sale of particular securities. *ICI I*, 401 U.S. at 629-34; *Securities Industry Association* v. *Board of Governors of the Federal Reserve System*, 468 U.S. 137, 145 (1984) ("*Bankers Trust I*"); *Schwab*, 468 U.S. at 220.

31 20 FEDERAL RESERVE BULLETIN 393 (1934); 20 FEDERAL RESERVE BULLETIN 750 (1934); 51 FEDERAL RESERVE BULLETIN 810 (1965); 12 C.F.R. § 218.110(d).

the activity does not represent more than 50 percent of the affiliate's total business activity or its single largest or most important activity. A similar decision was made in the *Chase* case.

After considering the submissions by the parties and other interested persons at the hearing and in post-hearing materials, the Board continues to be of the view, for the reasons expressed in full in *Bankers Trust*, that the term "engaged principally" in section 20 denotes any substantial activity of the affiliate.

In this regard, the Board has considered the argument by ICI regarding the now repealed section 19(e) of the Glass-Steagall Act. While section 19(e) and section 20 were designed to accomplish the same general objective and overlap to some extent in the case of a securities company affiliated with a member bank within a bank holding company system, section 20 does not contain the "formed for the purpose of" language found in section 19(e).

Moreover, nothing in the legislative history of the Glass-Steagall Act or the 1966 legislation which repealed section 19(e) indicates that the "engaged principally" standard of section 20 incorporated the "formed for the purpose of" standard. Section 19(e) was repealed, at the recommendation of the Board, because it was "doubtful" whether section 19(e) was "sufficiently useful" to justify its retention in light of the enactment of the Bank Holding Company Act.[32]

The Board has also considered the Supreme Court's discussion of section 19(e) in *ICI II*, 450 U.S. at 70 n.43. In the Board's view, the Court's statements merely reflect the view that if a company is formed in order to underwrite securities, one would expect the company to be "engaged principally" in that activity. The Court was not presented with a situation, such as that presented here, in which the company's largest activity is permissible government securities underwriting activities and its ineligible activities are insubstantial. In this regard, the Board is unaware of any instance of a member bank affili-

32 S. Rep. No. 1179, 89th Cong., 2d Sess. 12 (1966); *Bank Holding Company Act, Report of the Board of Governors of the Federal Reserve System to the Comm. on Banking and Currency, U.S. Senate*, 85th Cong., 2d Sess. 26 (Comm. Print 1958).

ated in a bank holding company system with a securities company that was covered by the "formed for the purpose of" language of section 19(e), but not by "engaged principally" language.

Finally, the Board notes that the "formed for the purpose of" language—like the "engaged principally" terminology in section 20—is susceptible to different meanings. For example, the "formed for the purpose of" language could be construed to refer to the situation where the company was specifically formed to underwrite ineligible securities and would not cover the situation where the company was formed for the purpose of commercial finance (as in the *Bankers Trust* and *Chase* cases previously approved by the Board) or to underwrite bank-eligible securities as in these cases.

Nevertheless, while the Board does not believe the "formed for the purpose of" standard has been incorporated in the "engaged principally" standard of section 20, the Board does note that section 19(e), because of its overlap with and close relationship to section 20, does tend to confirm the Board's conclusion that the "engaged principally" standard of section 20 must be read to cover any substantial ineligible activity of the affiliate in order to carry out Congressional intent to separate member banks from securities affiliates.

The Board has also considered Applicants' contention, reiterated at the hearing and in post-hearing materials, that the Board is required by the Supreme Court's *Agnew* decision to determine that the "engaged principally" standard of section 20 denotes only that activity of the affiliate that constitutes more than 50 percent of its total business activity or its single largest activity. The Board has carefully considered Applicants' position, but remains of the view that the Supreme Court in the *Agnew* case does not determine dispositively the meaning of "engaged principally" in section 20. As the Board noted in its *Bankers Trust* Order, section 20 was not at issue in *Agnew* because of the absence of a stockholder affiliation between the member bank and the securities company involved. 73 FEDERAL RESERVE BULLETIN 143, 144 (1987). Nor was any such determination necessary to the Court's decision regarding the

term "primarily engaged" in section 32, since even if the Court determined that the two standards were identical, it would not have been precluded from reaching the same conclusion—that "primarily" meant any substantial activity, given that "principally" can also mean any substantial activity. As was explained in the *Bankers Trust* Order, at the time the Glass-Steagall Act was passed, an accepted dictionary definition of principally included "important" and "primarily."

As noted in *Bankers Trust*, the Board believes its conclusion regarding the meaning of section 20 is particularly appropriate in light of the fact that to hold otherwise would mean that section 20 would apply to no one, since investment banking firms typically engage in numerous other activities in addition to securities underwriting and dealing. This rationale led the Court in *Agnew* to affirm the Board's interpretation that section 32 denoted any substantial activity. Indeed, such a view would permit member banks to establish the very affiliations with the nation's largest investment banking businesses that section 20 was precisely designed to prohibit.[33]

At the hearing, Applicants also disputed the Board's conclusion that common sense would suggest that Congress could not have intended to apply a less stringent standard where a member bank and an underwriter were affiliated through common stock ownership than was applied where a member bank and an

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33 In order to support its strict interpretation of section 32, the *Agnew* Court observed that the Act distinguished between firms primarily engaged and engaged principally in underwriting. 329 U.S. at 448. In the Board's view, the *Agnew* Court reached its decision on the meaning of "primarily engaged" on the basis of the terms and legislative intent of the statute. 329 U.S. at 447. Its subsequent references in the opinion to "principally" in section 20 were clearly meant to bolster its decision made on the basis of the terms and legislative intent of the statute. While the Court's observation is a part of the Court's reasoning, it is not a legally binding ruling on the scope of section 20. In addition, in the Board's view, the Court's supplemental argumentation should not be accorded controlling weight here, given that the Court in *Agnew* had no occasion to consider the fact that viewing "principally" to mean the chief or single largest activity would produce results that are inconsistent with what the Court understood to be the basic purpose of the legislation.

unaffiliated underwriter merely shared a common director. In *Bankers Trust*, the Board pointed out that Applicants' view of principally would mean that a member bank could be affiliated through common stock ownership with a securities company substantially but not predominantly engaged in underwriting, but could not establish a single management interlock with the company, a seemingly anomalous result in light of the greater potential in common ownership situations for adverse effects of the type that led Congress to enact the Glass-Steagall Act.[34] Applicants contend that Congress in fact intended to apply a more lenient standard in common ownership situations because the securities affiliate of a member bank would be subject to examination and rules limiting transactions between the member bank and its affiliates.

At the outset, the Board notes that there is nothing in the legislative history to support Applicants' view. Moreover, the Supreme Court has stated that Congress in 1933 rejected the view that examination and regulation of bank securities affiliates would address the concerns Congress perceived when commercial and investment banking functions are combined. *Bankers Trust I*, 468 U.S. at 147. Rather, Congress felt that most commercial and investment banking functions were "fundamentally incompatible." *Id.* The Board also notes that the examination authority and affiliate transaction restrictions contained in the Glass-Steagall Act were not comprehensive and did not foreclose the possibility of the type of adverse effects that concerned Congress and resulted in enactment of the Glass-Steagall Act. For example, section 23A of the Federal Reserve Act,[35] to which Applicants point, did not apply to purchases of assets by a member bank from an affiliate until 1982, thus allowing dumping of securities in a member bank or the purchase by a member bank of low quality assets from a securi-

34 73 FEDERAL RESERVE BULLETIN at 143, 144.

35 Banking Act of 1933, Pub. L. No. 66, § 13, 48 Stat. 162, 183 (codified at 12 U.S.C. 371c (1976), *amended by* Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 410, 96 Stat. 1469, 1515.

ties affiliate, a hazard Congress was specifically concerned with in 1933.

APPROPRIATE MEASURES OF "ENGAGED PRINCIPALLY"

Having determined that the "engaged principally" standard of section 20 denotes any substantial activity, the Board must determine whether, under the limitations proposed by the Applicants, their subsidiaries' ineligible underwriting and dealing activity would be substantial. In making this determination, the Board has been guided by the Congressional intent underlying section 20 of the Glass-Steagall Act to insulate member banks from the dangers Congress associated with the combination of commercial and investment banking by allowing member bank affiliates to underwrite and deal in ineligible securities only at a level that would not be substantial. Taking these factors into account in the *Bankers Trust* and *Chase* cases, the Board determined that where ineligible activity would not exceed 5 percent of the affiliate's gross revenues or 5 percent of the market for the type of security being placed or underwritten, the activity would not be substantial.

Applicants have suggested a number of differing methods for determining when an affiliate is "engaged principally" in underwriting activity, including limitations based on sales volume alone or on sales volume, assets devoted to the activity or income on a two out of three basis. The Board, however, continues to believe that the most appropriate measure of "engaged principally" is the gross revenue the affiliate derives from the ineligible underwriting and dealing activity relative to the revenue derived from its total business activities. This is consistent with the Board's practice under the "primarily engaged" standard of section 32 of the Glass-Steagall Act, which gives substantial weight to the size of the company's revenue from underwriting activity relative to its total revenue.[36] In addition, the Board believes it appropriate to consider the signifi-

36 Letter from the Board to the Federal Reserve Banks (August 11, 1958), *reprinted in Federal Reserve Regulatory Service* ("F.R.R.S."), ¶ 3-895.

cance of the organization's presence in the market for the particular activity, also a factor considered by the Board in prior rulings under the Glass-Steagall Act.[37]

As noted in the *Bankers Trust* Order, the Board believes that gross revenue is the appropriate test to determine whether a subsidiary is "engaged principally" because it is an objective and meaningful measure of the importance of the activity to the subsidiary as a whole and also reflects the level of risk involved in the activity, a major consideration behind enactment of the Glass-Steagall Act. In addition, a gross revenue test goes some way toward avoiding the potential for manipulation present in a test based solely on sales volume. Although gross revenues may be influenced to enlarge ineligible operations, the sales volume of a government securities subsidiary could be easily inflated by daily "matched book" operations[38] or be increased through churning of the affiliate's dealing activity in permissible securities in order to create a larger base against which ineligible activity would not appear to be substantial. The Board also notes that the average assets test suggested would not take into account ineligible underwriting activities which do not entail substantial or lengthy investment of the underwriting subsidiary's own funds.[39]

The Board has considered Applicants' comments at the hearing regarding the desirability of their proposed tests, including their view that the volume tests would not be subject to artificial increases because of increased costs and legal constraints. The

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37 *Id.*

38 Matched book activities would consist of repurchase and reverse repurchase agreements for government securities, used by dealers and their financial institutions customers for short term funding, hedging and arbitrage. As government securities dealers, Applicants' subsidiaries would have a high volume of such activity.

39 Bankers Trust's and Morgan's reliance on tests based on assets devoted to the activity, income and sales volume, on a "two out of three" basis, are similarly flawed because an affiliate could derive a substantial amount of its income from ineligible activity even though the ineligible activity met the asset and sales volume test, both of which, in the Board's judgment, would be open to increasing the base of eligible activity to support ineligible activity.

Board, however, continues to be of the view that a revenue test is the best overall measure under section 20, posing the fewest operational difficulties and giving the most accurate indication of the importance of the activity to the affiliate's total business operations. While Applicants argue there are a variety of different tests that could be applied to measure engaged principally status and that the tests should be tailored for each applicant, the Board believes that a uniform standard measure is desirable to assure a rule that would be simple to apply and enforce and to avoid unfairness in application among various applicants.

The Board also believes that in determining whether a company's underwriting activity is substantial it is important to consider in connection with gross revenue the affiliate's market share for the particular type of security underwritten. In the Board's judgment, the fact that an affiliate would be a major force in a particular securities market would be an evidentiary factor suggesting that the affiliate is "engaged principally" in underwriting securities. Thus, the Board has taken into account a firm's market share in decisions under the Glass-Steagall Act, particularly as it is related to the scope and extent of the firm's ineligible activity.[40]

In addition, the Board believes that a market share test would provide a useful and objective proxy for sales volume, which the Board believes is an important factor to be taken into account under the engaged principally test of section 20, and which the Board has considered in its decisions under section 32. Unlike the test based on sales volume of the subsidiary, the market share test would not be subject to manipulation, but would provide for consideration of the volume of business activity of the affiliate in absolute terms.[41]

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40 Letter from the Board to the Federal Reserve Banks (August 11, 1958) F.R.R.S. ¶ 3-895. *See also*, *e.g.*, Board letter dated September 30, 1947.

41 Applicants and the Antitrust Division of the Department of Justice argue that the Board is precluded from considering market share information in applying section 20, noting that the "engaged principally"

Finally, the Board believes that any decision regarding engaged principally status should take into account other factors and circumstances present in the pending applications. In the instant cases, the Board believes it significant that each of the three underwriting subsidiaries will maintain their fundamental nature as government securities dealers. They will underwrite a limited range of securities that are closely analogous to securities presently underwritten by member banks or to commercial banking functions, and at levels that would not be substantial relative to their eligible securities activities. Thus, the proposed limited expansion would not transform the government securities dealers into the type of securities affiliates engaged in the general investment banking and securities underwriting business that Congress intended to separate from member banks through section 20.

QUANTITATIVE LEVEL OF ACTIVITY PERMITTED UNDER SECTION 20

With respect to the appropriate quantitative level of activity permissible under the section 20 authorization, the Board has determined that a member bank affiliate would not be engaged principally or substantially in underwriting or dealing activity covered by section 20 if its gross revenue from that activity does not exceed a range of between 5 and 10 percent of its total gross revenues. The Board believes a similar range should apply to the market share test the Board has adopted under section 20.

The Board established this range by reference to the Board's past practice for many years in interpreting the "primarily engaged" standard in section 32, which, as noted, covers any substantial underwriting and dealing activity. This approach is, in the Board's judgment, consistent with the Congressional intent underlying section 20 to allow member bank affiliates to engage

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terminology focuses on the relative amount of activity within a particular company. However, the Board is not relying on market share information *per se*, but as a qualitative factor and as a substitute for a volume test, which is related solely to the activities of a particular affiliate but which the Board believes, in the context of these proposals, is not a reliable measurement criterion alone.

in underwriting and dealing activities at levels that are not substantial and thus would not raise problems of safety or soundness or risk for affiliated member banks.

In a number of cases over the years, the Board has developed a general guideline that a company would not be primarily or substantially engaged in activities covered by section 32 where those activities accounted for no more than 10 percent of the company's total revenue and the company's volume of such activities was not large in absolute terms or relative to other market participants.[42] If the firm was a leading securities underwriter with a large absolute volume of ineligible securities activities, however, the Board has found the firm to be primarily engaged in section 32 activities where the revenue the firm derived from these activities was between 5 and 10 percent of its total gross revenue.[43] Generally, where gross revenues from ineligible activity were less than 5 percent, the Board has not found the securities company to be primarily or substantially engaged in ineligible activity.[44]

In applying these principles to the present proposals, the Board notes that the volume of ineligible securities activity projected by Applicants could be large in absolute terms, and under their projections Applicants could be a substantial factor in the markets they propose to enter. Accordingly, the Board believes that the lower 5 percent end of the permissible range of activity under section 20 is the appropriate quantitative level for applying the gross revenue and market share tests to these proposals. The Board recognizes that this 5 percent threshold for gross income and market share represents a conservative approach to measuring the level of ineligible underwriting and dealing wthin the framework established by this Order and the Board's prior decisions under section 32. The Board will review

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42 Letter, dated December 14, 1981, *reprinted* in F.R.R.S. ¶ 3-939, and Board letter dated May 6, 1953.

43 *Id.* and, *e.g.*, Board letters, dated May 12 and June 22, 1954, May 22, 1959, *reprinted in* F.R.R.S. ¶ 3-896.

44 *E.g.*, Board letters, dated May 5, 1934 and May 7, 1962.

this determination, within one year, after Applicants have gained some experience in operating the proposed underwriting subsidiaries, to assess whether somewhat higher levels of activity up to 10 percent may be permissible consistent with the Board's interpretation of the term engaged principally as encompassing any activity that is substantial.

Applicants contend that the activity permitted under their proposed 10 to 15 percent of activity tests would not be substantial in the context of a government securities subsidiary that would derive 85 to 90 percent or more of activity from permissible activities under their standards for measurement. However, as noted above, the Board has carefully considered the standards and quantitative measures for determining whether an affiliate would be "engaged principally" under the provisions of section 20. The quantitative standards proposed by Applicants exceed the levels which the Board believes represent an appropriate interpretation of the provisions of section 20 that is consistent with both its language and the intention of Congress. In the Board's judgment, at the levels proposed by Applicants, the proposed affiliates would be clearly engaged principally in underwriting and dealing in securities.

In sum, the Board will not consider the underwriting subsidiaries to be engaged principally in ineligible underwriting and dealing activities under section 20 of the Glass-Steagall Act under the conditions established below for the conduct of the activity under the BHC Act, if

> (1) the underwriting subsidiaries derive no more than 5 percent of their total gross revenues from ineligible underwriting and dealing activity on average over any two year period,
>
> (2) their underwriting activities in connection with each particular type of ineligible security do not account for more than 5 percent of the total amount of that type of security underwritten domestically by all firms (or, in the case of commercial paper, the average amount of dealer-placed commercial paper outstanding) during the previous calendar year, and

(3) they limit the amount of each particular type of security held for dealing so as not to exceed the amount of the underwriting market share limitation described in paragraph (2) above.[45]

4. Proposed Interlocks Between Applicants' and Their Underwriting Subsidiaries are not Prohibited by Section 32.

Applicants anticipate that one or more officers of the bank holding company will serve as officers or directors of the subsidiaries that would conduct the proposed limited underwriting and dealing activity. The Board has previously applied the restrictions of section 32 to interlocking relationships between a securities firm and a bank holding company with one or more member bank subsidiaries. 12 C.F.R. § 218.114; F.R.R.S. ¶ 3-912. *See also* F.R.R.S. ¶ 3-948. The Board, however, has permitted an interlocking relationship between a securities firm and a bank holding company that mainly conducted nonbanking activities. F.R.R.S. ¶ 3-889.

In this case, the proposed interlocking relationships between the parent bank holding company and the underwriting subsidiaries would be permissible under section 32 because, even if it is assumed that the restrictions of section 32 should be applied to the parent holding company, under the limitations discussed above on the level of ineligible activity permitted to the subsidiaries, they would not be "substantially" or "primarily engaged" in ineligible activity.

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45 J.P. Morgan proposed to measure the amount of ineligible activity it would conduct through JPMS and JPMMF on a consolidated basis. Under that proposal, the total gross income from eligible and ineligible activity of both entities would be combined for purposes of the section 20 "engaged principally" limitation. The Board does not believe that section 20 permits two or more affiliates to combine their ineligible and eligible activity in order to determine whether as a whole the affiliates would be "engaged principally." By its terms, section 20 applies to each individual company affiliated with a member bank. Thus, JPMS and JPMMF each must adhere to the section 20 limitation.

None of the Applicants has proposed that an officer, director, or employee of its bank affiliates serve as an officer, director, or employee of the underwriting subsidiaries and, as discussed in Part III below, the Board has relied upon the absence of such interlocking relationships in its evaluation of the applications under the proper incident to banking standard of section 4(c)(8) of the BHC Act.

Part III. Bank Holding Company Act Analysis

In every application under section 4(c)(8) of the Bank Holding Company Act, the Board must find that the proposed activity is "so closely related to banking . . . as to be a proper incident thereto." This statutory standard requires that two separate tests be met for an activity to be permissible for a bank holding company. First, the Board must determine that the activity is, as a general matter, "closely related to banking." Second, the Board must find in a particular case that the performance of the activity by the applicant bank holding company may reasonably be expected to produce public benefits that outweigh possible adverse effects.[46]

Based on guidelines established in *National Courier Association* v. *Board of Governors of the Federal Reserve System*, 516 F.2d 1229, 1237 (D.C. Cir. 1975), a particular activity may be found to meet the "closely related to banking" test if it is demonstrated that:

(1) banks generally have in fact provided the proposed activity;

(2) banks generally provide services that are operationally or functionally so similar to the proposed activity so as to equip them particularly well to provide the proposed activity; or

(3) banks generally provide services that are so integrally related to the proposed activity as to require their provision in a specialized form.

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46 *See Schwab*, 468 U.S. at 210; *ICI II*, 450 U.S. at 57 n.22.

The *National Courier* guidelines are not, however, the exclusive basis for finding a proposed activity closely related to banking,[47] and the Board may consider any other basis that may demonstrate that the activity has a reasonable or close relationship to banking. 49 *Federal Register* 806 (1984). The U.S. Supreme Court stated in *Schwab* that the use of these factors by the Board in determining the closely-relatedness of an activity is reasonable and within the Board's discretion. 468 U.S. at 210 n.5, 214.

As a threshold matter, Citicorp and certain other commenters argue that the fact that these proposals are consistent with section 20 represents a Congressional determination that they are permissible for bank holding companies, a determination that may not be limited or revised under section 4(c)(8). This argument is premised on the Supreme Court's observation in *ICI II* that the BHC Act does not impose restrictions on the securities activities of banking institutions that are more severe than those in the Glass-Steagall Act. 450 U.S. at 60-61 n.26.

In the Board's view, however, the restrictions of the Glass-Steagall Act on the securities activities of member bank affiliates and the closely related to banking and proper incident to banking tests in section 4(c)(8) are by their terms independent provisions, each of which must be satisfied before a bank holding company may engage in securities activities. The *ICI II* opinion, the Board believes, supports this analysis.

In *ICI II*, the lower court had ruled that the BHC Act was intended to prohibit the Board from approving any securities activities for bank holding companies, even if they were permissible under the Glass-Steagall Act. The Supreme Court rejected this ruling, finding no implicit prohibition in section 4(c)(8) that is more restrictive than the Glass-Steagall Act.[48]

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47 516 F.2d at 1237.

48 450 U.S. at 77. The Court stated "Congress did not intend the BHC Act to limit the Board's discretion to *approve* securities-related activities as closely related to banking beyond the prohibitions already contained in the Glass-Steagall Act." (emphasis added). The Board notes

However, the Court's opinion did not address the relevant issue here—the scope of the Board's discretion under section 4(c)(8) to *deny* or place prudential limitations on securities activities that, while consistent with the Glass-Steagall Act, may not comply with the separate requirements of the BHC Act. Moreover, Applicants have produced no evidence in the legislative history that the Board was not to exercise its discretion under the closely related to banking and public benefits tests of section 4(c)(8) regarding specific proposals merely because they involve securities activities that are not unlawful under the Glass-Steagall Act.

A. Closely Related to Banking Analysis.

After carefully considering the facts of record, the Board concludes that underwriting and dealing in commercial paper, municipal revenue bonds and 1-4 family mortgage-related securities, under the limitations discussed in this Order, are closely related to banking, because banks provide services that are so operationally and functionally similar to the proposed services that banking organizations are particularly well equipped to provide such services. As the Board has previously noted, the proposed activities are a natural extension of activities currently conducted by banks, involving little additional risk or new conflicts of interest under the framework established in this Order, and potentially yielding significant public benefits in the form of increased competition and convenience and lower cost.[49] On

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that the legislative history to which the Court refers to support this conclusion indicates that the BHC Act was *not* intended to liberalize the Glass-Steagall Act. That legislative history does not indicate, as Applicants claim, that activities that do not violate the Glass-Steagall Act are exempt from scrutiny under the standards of the BHC Act. Under the plain terms of the BHC Act, such activities clearly are not permissible for bank holding companies unless they pass muster under the standards of section 4(c)(8).

49 *See, e.g., Financial Restructuring: The Road Ahead: Hearings on H.R. 5342, 4506 and 3537 Before the Subcomm. on Telecommunica-*

this basis, the Board has urged the Congress to authorize these activities for bank holding companies as part of a Congressional reevaluation of the powers of banking organizations generally. This view is not held by the Board alone. The other federal banking agencies as well as the U.S. Departments of Treasury and Justice have also supported these activities.[50]

Accordingly, and for the reasons set forth in the *Chase* decision, the Board believes that underwriting and dealing in commercial paper is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. For the reasons set out below, the Board also concludes that underwriting and dealing in the proposed municipal revenue bonds and 1-4 family mortgage-related securities is closely related to banking.[51]

Member banks are actively engaged pursuant to specific legislative authorization in a variety of underwriting and dealing activities that are closely analogous to the proposed municipal revenue bond and mortgage-related securities underwriting activities. Section 16 of the Glass-Steagall Act authorizes member

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tions, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 98th Cong., 2d Sess. 91 (1984) (Statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System), reprinted in 70 FEDERAL RESERVE BULLETIN 312, 316 (1984); Statement of Chairman Volcker Before the Subcomm. on Commerce, Consumer & Monetary Affairs of the House Comm. on Government Operations (June 11, 1986), reprinted in 72 FEDERAL RESERVE BULLETIN 541, 549 (1986). *See also* S. Rep. No. 560, 98th Cong. 2d Sess. 15-16 (1984).

50 *Competitive Equity in the Financial Services Industry: Hearings on S.2181 Before the Senate Comm. on Banking, Housing, and Urban Affairs* ("Hearings on S.2181"), 98th Cong., 2d Sess. 1221, 1274, 1550, 1714 (1984) (Statements of C. Todd Conover, Comptroller of the Currency, William M. Isaac, Chairman, F.D.I.C., Douglas H. Ginsburg, Deputy Assistant Attorney General, U.S. Department of Justice, and Donald T. Regan, Secretary of the Treasury, respectively).

51 While Applicants have applied to underwrite and deal in mortgage-related securities generally, the Board believes that, at least on the current record, only underwriting and dealing in mortgage-related securities backed by 1-4 family residential mortgages will avoid significant risks and other adverse effects, as explained below.

banks to underwrite and deal in certain municipal revenue bonds (generally, those issued for housing, university or dormitory purposes), as well as municipal general obligation bonds ("GOs").[52] 12 U.S.C. 24 Seventh. Bank-eligible municipal revenue bonds accounted for between 31 and 52 percent of all municipal revenue bonds issued during the years 1980 to 1984, with banks accounting for between 19 to 26 percent of the underwriting market.[53] Banks have also historically underwritten a major share of new general obligation bond issues.[54]

Section 16 also authorizes member banks to underwrite and deal in mortgage-related securities that are issued or guaranteed by federal agencies. As Congress has recognized, banks are extensively involved in this activity.[55]

In addition to the fact that banks already underwrite and deal in certain types of municipal revenue bonds and mortgage-related securities, banks have developed extensive expertise in underwriting and dealing in U.S. government and agency securities and are among the nation's leading underwriters of these securities. For example, banks or bank affiliates constitute 17 of the 40 primary dealers in the government securities market and are among its largest participants.[56] In addition, banks are among the nation's largest underwriters of general obligation bonds.

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52 GOs represent a general debt obligation of a municipality, while a revenue bond represents a charge against the revenues of a facility or project financed by the bonds.

53 *Bank Eligible Revenue Bonds Compared to Total Revenue Bonds* (Exhibit E) and *Bank-Eligible Revenue Bonds Managed by Banks* (Exhibit F), Citicorp Application.

54 Dealer Bank Ass'n Comment, Exhibit III, Tables IIb and IIIb (July 22, 1985); Citicorp Application , p. 20, citing data obtained from Securities Data Corporation.

55 *See* S. Rep. No. 293, 98th Cong., 1st Sess. (1983).

56 For example, in 1984, banks accounted for nearly 30 percent of all U.S. government obligations underwritten. Department of Treasury, *Treasury Bulletin*, Fall 1984, Table PDO4.

In the Board's view, definite functional and operational similarities exist between the securities that member banks may underwrite and deal in and the municipal revenue and mortgage-related securities proposed by Applicants for their underwriting subsidiaries. The techniques involved in underwriting and dealing in these bank-eligible securities are the same, or substantially the same, as those that would be involved in conducting the proposed municipal revenue and mortgage-related securities activities. In each case the underwriter must perform substantially identical functions of credit evaluation and analysis, negotiation or bidding, distribution, and dealing. For example, investment banking firms that underwrite and deal in municipal revenue bonds generally utilize the same personnel and marketing techniques for their activity in general obligation bonds.[57]

The Board also notes that the evaluation and credit analysis that would be performed in connection with underwriting municipal revenue bonds and mortgage-related securities is functionally and operationally similar to the evaluation and credit analysis banks conduct when making loans to customers and in connection with their investment advisory and trust activities. In addition, Applicants' role in advising issuers in structuring an offering and contacting potential purchasers is functionally and operationally similar to a bank's role in advising customers and arranging loan participations and syndications.

The Board also believes that underwriting and dealing in these securities is functionally and operationally similar to the role of a bank in underwriting and dealing in money market instruments, establishing mortgage pools and evaluating the underlying risks of the constituent elements in a pool, advising municipalities and other issuers and assisting them in the pri-

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57 R. Plotkin, *What Meaning Does Glass-Steagall Have For Today's Financial World?*, 95 Banking L.J. 404, 412 (1978).

Municipal securities dealers and brokers, including bank dealers, are subject to the same regulatory system developed by the Municipal Securities Rulemaking Board under Section 15B of the Securities Exchange Act. 15 U.S.C. § 78o-4.

vate placement of their notes, and generally assessing credit and interest rate risk.[58]

Protestants contend that there is a major difference between underwriting activities permitted member banks under the Glass-Steagall Act and those proposed by Applicants, because bank-eligible securities are generally offered to dealers through competitive bidding while the price of most revenue bonds and other securities involved in Applicants' proposals is usually negotiated. Given the wide commercial bank participation in the underwriting of and dealing in U.S. government, municipal and other bank-eligible securities as a whole, the Board believes that banks are sufficiently familiar with negotiating processes as well as those involved in competitive bidding. The Board also notes that banks are involved in the negotiating process through their private placement activities for ineligible securities, including ineligible municipal revenue bonds, and their securities activities overseas.[59] Moreover, in the case of municipal securities specifically, this distinction is not significant because many revenue issues are offered by public bid, and the number of general obligation bonds sold by negotiation has been increasing.[60]

With respect to mortgage-related securities, the Board notes that the operations and functions (including credit and cash flow analysis, bidding process, distribution and dealer activities) involved in underwriting and dealing in bank-eligible mortgage-related securities and 1-4 family mortgage-backed securities are virtually identical, regardless of whether a federal or private entity issues or guarantees the securities involved.[61] Because the mortgage-backed securities proposed for the subsidi-

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58 *See* Hearings on S.2181 at 1612 (Statement of Paul A. Volcker).

59 *See* Comptroller of the Currency, Federal Deposit Insurance Company, and Federal Reserve Board, Commercial Bank Private Placement Activities (1978); 12 C.F.R. 211.5(d)(13) (underwriting, distributing, and dealing in debt and equity securities outside the United States).

60 F. Fabozzi, S. Feldstein, I. Pollack, F. Zarb, *The Municipal Bond Handbook*, Volume One 172-73 (1983).

61 *See generally* C. Edson and B. Jacobs, *Secondary Mortgage Market Guide* (1985).

aries are not directly issued or guaranteed by the federal government or government-sponsored agencies, the subsidiaries will be required to conduct a more extensive credit analysis and evaluation of issuers and underlying mortgages than in underwriting bank-eligible mortgage-related securities. Given the experience of Applicants and banking organizations generally in evaluating credit in lending and investment functions[62] as well as in permissible underwriting activities where credit analyses are commonly made, for example, in connection with underwriting general obligations of States and municipalities, the Board does not believe this difference between bank-eligible mortgage-related securities and Applicants' proposed activity is significant. In this regard, the Board notes that banks underwrite substantial amounts of housing-related municipal bonds,[63] an activity that involves substantially the same credit analysis function as will be required for Applicants' mortgage-related securities.

Based on the foregoing analysis, the Board concludes that banking organizations, including Applicants, perform services that are functionally and operationally similar to the proposed activities of underwriting and dealing in certain municipal revenue bonds and 1-4 family mortgage-related securities and that they would be particularly well equipped to provide these underwriting and dealing services.

Citicorp and Bankers Trust also propose to underwrite and deal in CRRs. Although they note certain similarities between CRRs and mortgage-related securities and between banking activities involving the underlying loan obligations represented by those securities, the Board does not believe that the record before the Board at the present time provides a sufficient basis for it to make the formal finding required by the BHC Act that underwriting and dealing in CRRs is closely related to banking and a proper incident thereto. The market for CRRs is rela-

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62 *See, e.g.*, 12 C.F.R. 1.5, 1.8; M. Stigum, *The Money Market* 657 (2d ed. 1983).

63 *See* S. Rep. No. 293, 98th Cong. 1st Sess. 9 (1983) ("National banks . . . are currently intimately involved in mortgage finance including mortgage revenue bonds and the federal mortgage market agencies.").

tively new and untested compared to the market for the 1-4 family mortgage-related securities and municipal revenue bonds involved in these proposals. As Citicorp notes, the securitization of consumer loans and receivables is now in its early stages, and for that reason, "it is impossible to predict with certainty the direction in which this activity will evolve."[64] The Board, however, will reconsider this matter within the next sixty days on the basis of fuller submissions by Applicants regarding the types of assets that will be securitized, the manner in which this will be accomplished, and other matters bearing on risk. This will enable the Board to examine appropriately the risks involved and whether any safeguards are necessary to meet the requirements of the BHC Act.

B. Proper Incident to Banking Analysis.

In order to approve an application to engage in a nonbanking activity under section 4(c)(8) of the Act, the Board must determine that a proposed activity is a "proper incident" to banking by determining whether the performance of the activity by the applicant bank holding company may reasonably be expected to produce public benefits, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. 12 U.S.C. § 1843(c)(8). Based upon the facts of record and for the reasons and subject to the limitations set out below, the Board finds that the proposed underwriting and dealing activities (other than for CRRs) may reasonably be expected to result in substantial public benefits that outweigh possible adverse effects.

1. Public Benefits.

The Board believes that the expansion of Applicants' activities to include underwriting and dealing in municipal revenue bonds, 1-4 family mortgage-related securities, and commercial paper should result in substantial public benefits in the form of

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64 Letter, dated April 19, 1985, to Federal Reserve Bank of New York, 8-9.

increased competition, greater convenience and gains in efficiency.

Increased Competition. The Board has previously recognized that the *de novo* expansion by a bank holding company into nonbanking activities generally may be expected to be procompetitive and result in increased competition.[65] These proposals represent a *de novo* expansion by Applicants into new segments of the markets for commercial paper, municipal revenue and 1-4 family mortgage-related securities, and thus may be expected to increase competition. The Board concluded in the *Chase* case that the expansion of a bank holding company's activities in the commercial paper market, which is highly concentrated, would foster competition.

Concentration ratios for those segments of the mortgage-related and municipal securities markets in which banking organizations have not participated are significantly higher than those for the bank-eligible segments of these markets. The introduction of new competitors into these markets may be expected to reduce concentration levels and, correspondingly, to reduce financing costs, underwriting spreads, and increase the availability of services to issuers.[66] Increased competition may be expected to benefit smaller and infrequent issuers, such as

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65 *See, e.g.*, section 225.24 of Regulation Y (12 C.F.R. 225.24); 49 *Federal Register* 814 (1984). Congress has also recognized that public benefits of increased competition and innovation may be anticipated through *de novo* expansion by bank holding companies into nonbanking activities. H.R. Rep. No. 1747, 91st Cong. 2d Sess. 16-17 (1970); S. Rep. No. 1084, 91st Cong. 2d Sess. 15-16 (1970); *Alabama Ass'n of Insurance Agents* v. *Board of Governors of the Federal Reserve System*, 533 F.2d 224, 249 (5th Cir. 1976), *cert. denied*, 435 U.S. 904 (1978).

66 *See* U.S. Department of the Treasury, Public Policy Aspects of Bank Securities Activities 34 (1975); Bank Holding Company Legislation and Related Issues: *Hearings on H.R. 2255, 2747, 2856 and 4004 Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 96th Cong. 1st Sess. 1299-1302 (1979) (statement by J. Charles Partee, Member, Board of Governors of the Federal Reserve System); S. Rep. No. 560, 98th Cong., 2d Sess. 15-16 (1984).

rural communities, which currently have relatively few choices among underwriters.

Benefits in the form of reduced financing costs and increased availability may be expected to accrue as well to the original borrowers under mortgage-related and municipal securities—homeowners and public entities—whose ability to borrow is directly related to the secondary market for their liabilities. Increased competition may also foster innovation among participants in these markets.

In this regard, the report of the Senate Committee on Banking, Housing and Urban Affairs on the proposed Financial Services Competitive Equity Act (S. 2851, 98th Cong., 2d Sess. (1984)) concluded that authorization for bank holding companies to underwrite municipal revenue bonds "will result in significant benefits to governmental issuers of these obligations and thus to their residents and taxpayers who must ultimately bear the cost of public borrowing."[67] The Board also notes that associations of state and municipal governmental organizations, including the National Governors Association and the National League of Cities, support bank holding company entry into municipal revenue bond underwriting in order "to increase competition for underwriting municipal revenue bonds and in view of the potential for this initiative to reduce significantly the cost of revenue financing."[68] National trade associations of home builders and realtors support bank holding company entry into the mortgage-backed securities underwriting business in order to increase competition.[69]

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67 S. Rep. No. 560, 98th Cong., 2d Sess. 16 (1984).

68 Letter from the National Governors Association to Jake Garn, Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (June 12, 1984), quoted in S. Rep. No. 560, 98th Cong., 2d Sess. 16 (1984); letter to the Board from the National League of Cities (July 19, 1985) (commenting on Citicorp application).

69 Letters to the Board from the National Association of Home Builders (July 22, 1985) and from the National Association of Realtors (July 18, 1985) (commenting on Citicorp application).

Greater Convenience and Increased Efficiency. The Board also finds that approval would result in public benefits in the form of greater convenience to customers and increased efficiency in the provision of the proposed services. As the Board has previously concluded, underwriting and dealing in commercial paper by a bank holding company would produce these public benefits.

Bank holding companies would be able to offer their borrowing customers an additional service and means of financing that may be more economical for the borrower. In addition, Applicants would be able to offer commercial paper to the same institutional investor customers that currently purchase other money market instruments, such as short-term U.S. government securities, certificates of deposit and bankers' acceptances, thereby increasing services to buyers of money market instruments and leading to greater efficiency in the market for short-term debt.

Issuer-customers of Applicants' existing underwriting services in municipal and mortgage-related securities would no longer be restricted to the bank-eligible segments of the markets for those securities when doing business with these bank holding companies. The increase in the number of dealers in these securities would also be likely to enhance liquidity in the markets for these securities, thereby increasing market efficiency.

More efficient operation of the markets for the proposed securities would benefit investors and issuers who are customers of Applicants and other market participants by narrowing the underwriter's and dealer's spread on sales transactions and making it easier to match buyers and sellers of the proposed securities.

2. Adverse Effects.

In the Board's December 1986 decision permitting Bankers Trust to place commercial paper as agent, the Board adopted a framework which had been put in place by Bankers Trust in order to address the possibility of adverse effects, such as unsound banking practices or conflicts of interest, that the Board must consider under the "public benefits" test in section

4(c)(8).[70] When the Board ordered a hearing on these applications, the Board requested specific comment on whether the Bankers Trust framework or other limitations that the Board was considering and that were listed in the Hearing Order should be adopted with respect to these proposals.

Comments of Interested Persons. The protestants believe that significant adverse effects are presented by the proposal, including potential conflicts of interest caused by the underwriting subsidiaries' "salesman's stake" and promotional incentives in the securities it underwrites or deals in, loss of public confidence in the bank if the affiliate experiences losses on its securities activities, risk to the bank holding company as a result of possible underwriting losses by the affiliate, undue concentration of resources resulting from greater domination of financial markets by banking organizations, and unfair competition, such as the affiliate obtaining funding from low cost bank deposits or access to confidential customer information held by the bank.

The protestants and several other commenters also expressed doubts as to the effectiveness of the suggested conditions and limitations to address these concerns. The SIA believes conditions such as those listed in the Board's Hearing Order would be inadequate to address all possible concerns. Salomon Brothers expressed the view that where the same or affiliated entities are both lenders and underwriters, no safeguards would be fully adequate to prevent abuses. Other protestants believe that restrictions must also be directed at establishing a "level playing field" for banking organizations and investment banking firms engaged in the proposed activities.

Applicants and certain other commenters contend no significant adverse effects would arise under these limited proposals involving securities with which bank holding companies have experience, particularly in light ot the voluntary controls Applicants would impose on themselves to limit risk and prevent conflicts and the applicable requirements of securities laws and

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70 The Board adopted a similar set of limitations to address possible adverse effects in approving the application by Chase to underwrite and deal in commercial paper.

regulations. A few commenters believe the Board should establish further conditions to address risk or conflicts and to insulate the underwriting subsidiaries from their affiliated banks, such as a capital adequacy requirement for the underwriting subsidiary and limitations on transactions between the subsidiary and bank affiliates.

Applicants and certain other banking organizations objected to a number of the conditions listed in the Board's Hearing Order. In general, Applicants believe that any conflicts presented by the proposals are similar to the conflicts already successfully handled by bank holding companies and investment banking firms and that existing regulation by the SEC of broker-dealers, rules of the National Association of Securities Dealers ("NASD") and the Municipal Securities Rulemaking Board ("MSRB") applicable to broker-dealers trading in the proposed securities, and fiduciary requirements under common law and banking regulation are adequate to address the Board's concerns. They commented that a number of the conditions being considered by the Board to address possible conflicts of interest could interfere with their ability to compete or would be unnecessary or confusing in light of existing regulation.

Based on the record of the applications, and after careful consideration of the comments of interested parties, the Board finds that the potential for conflicts of interest, unsound banking practices, as well as other adverse effects are not likely to result from these proposals under the conditions and limitations established by the Board in this Order for the conduct of the proposed activities as well as the various statutory protections Congress has provided over the years to regulate the conduct of these activities. As discussed below, the Board has carefully considered the comments relating to the need for specific limitations and has concluded that, although existing regulation addresses certain of the concerns of the Board, there are areas in which the existing regulatory framework has not been demonstrated on the present record to be effective where commercial banking and investment banking organizations are affiliated. The Board notes that the BHC Act addresses broader concerns relating to safety and soundness and maintenance of public

confidence in banking organizations and impartiality in the credit-granting process, concerns that are not addressed by the statutory and regulatory provisions relating to investor protection to which Applicants refer. Accordingly, the Board has determined that this existing regulatory framework needs to be supplemented through additional limitations drawn from the list on which the Board sought comments at the hearing in order to address issues peculiar to the affiliation of ineligible securities underwriters and banking organizations.

General Considerations. At the outset, the Board notes that there are several general considerations that support a finding that these proposals as limited by Applicants and in this Order would not produce significant adverse effects. First, a great many of the adverse effects the Board is charged with considering under the public benefits test of section 4(c)(8), such as unsound banking practices and conflicts of interest, relate to potential damage to the holding company's subsidiary bank that might result from the conduct of proposed nonbanking activity. Accordingly, while a bank cannot be completely insulated from the fortunes of an affiliated nonbanking subsidiary, the Board believes that the greater the extent to which the nonbanking activity of a nonbank subsidiary of a holding company is insulated, both structurally and operationally, from the holding company's subsidiary banks, the less likely it is that adverse effects related to the conduct of the nonbanking activity will affect affiliated banks.[71]

In determining that adverse effects are not likely in these cases, the Board places substantial reliance on the fact that the proposed underwriting and dealing activities would be separated from the activities of Applicants' subsidiary banks, both through separate incorporation and through financial and operational limitations, explained below, that are specifically designed to ensure that all aspects of the proposed securities activities are insulated in operation from subsidiary depository institutions. For example, the proposed activities will not be

71 *Bankers Trust*, 73 FEDERAL RESERVE BULLETIN at 149, quoting *National Westminster Bank, PLC*, 72 FEDERAL RESERVE BULLETIN 584, 588 (1986), *petition for review pending*, No. 86-1412 (D.C. Cir.).

conducted by Applicants' subsidiary banks or by the banks' personnel. Each Applicant has agreed that its underwritng subsidiary will have no common officers, directors, or employees with Applicant's subsidiary banks. The Board believes that the prohibition on personnel interlocks should extend to any thrift subsidiary, as well, in order to assure that all federally-insured depositors are protected as much as possible. In addition, the Board requires that affiliated banks may not act as agents for or engage in marketing activities on behalf of the underwriting subsidiaries. The underwriting subsidiaries should also have offices separate from any affiliated bank.[72]

Moreover, transactions between the affiliated banks and the underwriting subsidiaries will be strictly limited, as discussed below. The underwriting subsidiaries will also be subject to a number of disclosure requirements designed to ensure that the public will not confuse the underwriting subsidiaries with their affiliated banks, including a requirement that the underwriting subsidiaries provide their customers with a special disclosure statement describing the difference between them and their affiliated banks. Limitations are also imposed preventing self-dealing in transactions between these subsidiaries and their affiliated banks acting in a fiduciary capacity. The Board also requires that the underwriting subsidiaries' access to customer records of the affiliated banks be limited and that the subsidiaries' affiliates be restricted in extending credit to customers for the purchase of securities from the subsidiaries during the course of the underwriting.

Under limitations imposed by the Board, the underwriting subsidiaries would be capitalized on a stand-alone basis, that is, each subsidiary must be capitalized independently of the parent

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72 The Board notes that the FDIC has recently proposed to amend its regulations governing the securities activities of affiliates of nonmember banks to provide that if the bank conducts business in the same location as the affiliate the bank must use physically separate offices or office space from that used by the affiliate. Such offices would have to be clearly and prominently identified so as to distinguish the bank from the affiliate. 52 *Federal Register* 11,492, 11,498 (April 9, 1987).

company and its subsidiary banks in accordance with industry norms.

Second, the limited expansion of activity proposed in the applications and the fact that the subsidiaries would remain fundamentally government securities dealers further support the findings that the specific adverse effects cited by the protestants are not likely to be a significant product of these proposals. The activity of each underwriting subsidiary with regard to ineligible securities would be limited in terms of income and market share so that they would not be substantial in the context of the subsidiary's overall operations and, moreover, each subsidiary would underwrite only a limited number of securities that are closely analogous, if not in most respects identical, to securities banks are authorized to underwrite and deal in or to commercial banking products. The fundamental nature of these subsidiaries would not be changed. They would remain government securities dealers and would in no sense be engaged in a full investment banking business.

Unsound Banking Practices. The Board has considered the extent to which these proposals would result in unsound banking practices or excessive financial risk to Applicants or their subsidiary banks through the underwriting subsidiaries' activities or through imprudent financial transactions with the underwriting subsidiaries or made for their benefit. In addition, the Board has considered whether the public association and economic union between the underwriting subsidiaries and their banking affiliates could lead to a loss of public confidence in Applicants' subsidiary banks if losses are sustained by the underwriting subsidiaries or by persons dealing with those subsidiaries.

Risk of Loss. Protestants allege that the proposals will result in unsound banking practices because the underwriting subsidiaries, acting as principals with respect to ineligible securities, could lose their own funds as a result of these operations. Such losses, protestants allege, could damage public confidence in affiliated banks and the parent company's ability to raise funds to provide to subsidiary banks.

The Board finds, however, that the risk of loss to Applicants or their underwriting subsidiaries as a result of these proposals is not excessive or inconsistent with prudent banking standards. As a preliminary matter, the Board notes that Applicants have applied to conduct a restricted form of underwriting and dealing that would be limited to securities that Congress has specifically authorized member banks to hold for their own account in the exercise of prudent banking judgment.[73] In fact, Congress recently authorized national banks to invest without limitation in private mortgage-related securities subject to regulations of the Comptroller of the Currency[74] on the basis that these securities do not jeopardize the safety and soundness of depository institutions because of the low-risk characteristics of the investment, *i.e.*, "a pool of many mortgages with relatively low default risk as well as mortgage insurance on both the individual mortgages and the pool."[75] Thus, to the extent the underwriting subsidiaries may hold ineligible securities for their own account as a result of these proposals, they will not be subject to any excessive or unmanageable risk of loss.

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73 A bank may exercise its prudent banking judgment to invest in any amount of the proposed mortgage-related securities if it is satisfied with the creditworthiness of the obligor. 12 U.S.C. § 24 Seventh; 12 C.F.R. 1.3 and 1.4. In the exercise of its prudent banking judgment, a bank may invest in the proposed municipal revenue bonds if it believes the obligor is creditworthy and the security is marketable. 12 U.S.C. § 24 Seventh; 12 C.F.R. 1.3 and 1.5. Banks have traditionally purchased commercial paper for their own account. *See Bankers Trust I*, 468 U.S. at 158 n.11.

74 Pub. L. No. 98-440, 98 Stat. 1691 (Oct. 3, 1984), amending 12 U.S.C. § 24.

75 S. Rep. No. 293, 98th Cong., 1st Sess. 6 (1983). Statistics also indicate that the performance of mortgage-related securities based on conventional (*i.e.*, non-federally insured) mortgages has been comparable to those issued or backed by the Federal agencies and/or Federal Housing Administration ("FHA") insurance. M. Waldman and S. Guterman, *Mortgage Securities: 1972-84, Historical Performance and Implications for Investors* (Salomon Brothers Inc, March 1985).

The Board, however, recognizes that in addition to credit risk, an underwriter and market maker also assume the risk of adverse changes in the market price of the securities involved. In addition, an underwriter or market maker may hold at any one time a substantially greater proportion of securities of a particular issuer than would be likely in the case of investors and must generally be prepared to provide liquidity for an issue. Nevertheless, the Board believes that the limited extension of activities proposed for the underwriting subsidiaries, which is substantially similar to operations safely and soundly being conducted presently by member banks, would not result in significant or excessive risk.[76] The risks associated with underwriting and dealing in any revenue bond, whether eligible or not, are generally a function of the price volatility of the security, as well as the cash flow and viability of the project being financed. These risks are not, in the Board's view, significantly greater for ineligible revenue bonds than for eligible bonds, given the very close functional similarity between the two kinds of obligations.[77] The same analysis applies to the proposed underwriting of ineligible mortgage-backed securities, whose risk characteristics are only slightly different from those of certain kinds of eligible mortgage-backed securities.

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76 *See* S. Rep. No. 560, 98th Cong., 2d Sess. 16 (1984).

The record does not show that there has been any particular safety and soundness or conflict of interest or abuses in the case of banks underwriting municipal general obligation bonds. *See Moratorium Legislation and Financial Institutions Deregulation: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. 192 (1983) (statement of Paul A. Volcker).

77 In some cases, ineligible revenue bonds have higher ratings and lower yields than municipal securities eligible for underwriting by banks, including general obligation bonds. For example, according to Moody's 1985 Municipal and Government Manual, the general obligations bonds of New York City, which are eligible for bank underwriting, were rated "Baa," whereas the ineligible revenue bonds of related agencies, such as the New York City Transit Authority and the Triborough Bridge and Tunnel Authority were rated "Aaa" and "Aa," respectively.

Finally, as the Board recognized in *Chase*, underwriting and dealing in commercial paper is an activity that is similar to loan syndication and other similar operations presently conducted safely and soundly by member banks and involves a security that member banks may invest in as principal.[78]

The risk of underwriting and dealing in these securities is further mitigated by Applicants' experience in performing key functions that are similar to those performed by an underwriter or dealer in these types of debt securities, including credit analysis, evaluation of interest rate risk, financial planning, advice to issuers and assisting them in the private placement of their notes, and risk reduction techniques, such as hedging, diversification and other precautions applicable to the proposed activities.

Moreover, the Board notes that the underwriting subsidiaries will be subject to regulation under the federal securities laws. In particular, the subsidiaries will register with the SEC as broker-dealers and will be subject to financial reporting, anti-fraud and financial responsibility rules applicable to broker-dealers. These rules include the SEC's net capital rule (SEC Rule 15c3-1), which imposes capital requirements on broker-dealers that vary with the degree to which a broker-dealer acts as a principal and deals with the public. As noted below, Applicants' subsidiaries will maintain capital in excess of these requirements. In addition, the underwriting subsidiaries will be subject to the rules and regulations of the NASD and the MSRB. These requirements provide further protection against financial loss as a result of the proposed activities. The Board has previously recognized that in certain areas regulation under the federal securities laws is relevant to and may mitigate the Board's concerns

78 In addition, the Board has previously noted that the market risk associated with underwriting commercial paper is minimal. Before commercial paper is issued, dealers usually survey prospective purchasers to ascertain likely interest. Thus, the probability that the underwriter would incorrectly assess market conditions and would accordingly be required to hold large amounts of commercial paper for its own account is small. In any event, the short-term maturity of commercial paper, thirty days on average, limits the potential for large capital losses to the underwriting subsidiary.

over the possibility of adverse effects under section 4(c)(8) of the BHC Act.[79]

While the Board finds that the proposed activities do not generally present concerns about undue financial loss, the Board believes that underwriting and dealing in certain limited types of ineligible securities could give rise to unacceptable risk of loss, at least as indicated by the record currently before the Board. Therefore, the Board believes it prudent at this stage to place conditions on the types of ineligible securities that may be underwritten and dealt in pursuant to this Order. While municipal revenue bonds have not generally been characterized by substantial risk, certain new types of revenue bonds are being developed, particularly in the area of securities used to promote industrial development, that are riskier than traditional municipal securities or that may be operationally and functionally similar to corporate debt securities. Accordingly, the Board believes it appropriate to require that the underwriting subsidiaries may not, without further authorization from the Board, underwrite or deal in municipal securities other than those that are rated as investment quality (*i.e.*, in one of the top 4 categories) by a nationally recognized rating agency.[80] The Board notes that most of the types of revenue bonds Applicants propose to underwrite have not generally been associated with excessive risk and are frequently backed by insurance or letters of credit furnished by third parties, which further reduces the risk associated with these securities.

In light of recent adverse developments in the market for mortgage-related securities involving banking and thrift organizations, the Board also believes it appropriate to impose spe-

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79 *E.g.*, *BankAmerica Corporation*, 69 FEDERAL RESERVE BULLETIN 105, 113 (1983); *Fidelcor, Inc.*, 70 FEDERAL RESERVE BULLETIN 368, 369 (1984).

80 The Board notes that the underwriting subsidiaries proposed to underwrite "public ownership" industrial development bonds ("IDBs"), *i.e.*, tax exempt bonds where the issuing municipality or the state or local governmental unit on behalf of which the bonds are issued is treated for federal income tax purposes as the sole owner of the facility being financed. Without further approval from the Board, the underwriting subsidiaries may underwrite or deal in only these IDBs.

cific limitations on the types of such securities offered by the underwriting subsidiaries. Accordingly, the Board believes that Applicants' proposals to underwrite and deal in ineligible residential mortgage-related securities should be limited to obligations that are secured by or represent an interest in 1-4 family residential mortgages until additional experience is gained in other residential mortgage-related securities. In the Board's view, there are potentially greater risks associated with larger multi-family housing projects, which often have an element of commercial real estate development. The Board believes that mortgage-backed securities (other than those collateralized by 1-4 family residential mortgages) may in many instances involve significantly different and greater risk characteristics more akin to corporate underwriting, which the current record does not demonstrate may be handled safely with minimum risk within a bank holding company system. In addition, the mortgage-related securities collateralized by 1-4 family residential mortgages must be rated as investment quality (*i.e.*, in one of the top 4 categories) by a nationally recognized rating agency.

Finally, to insure that the subsidiaries' commercial paper activities remain limited to the kinds of obligations normally sold in the recognized commercial paper market, the underwriting subsidiaries may underwrite and deal in only prime quality, short-term obligations that are exempt from the registration requirements of the Securities Act of 1933 and that have minimum denominations of at least $100,000.[81]

The Board also finds that even if the underwriting subsidiaries were to encounter losses associated with the conduct of the proposed activities, these losses are not likely to represent any unwarranted risk of loss to the parent companies or Applicants' other subsidiaries under the various limitations and conditions discussed in this Order, which insulate the underwriting and dealing activities, both structurally and operationally from Applicants' subsidiary banks. These limitations serve to prevent

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81 Commercial paper that qualifies for exemption under that Act typically is short-term (maturity of less than nine months), has large minimum denominations, and is issued by the largest and financially strongest corporations.

the underwriting subsidiaries' functions from draining the resources of the banks or from otherwise producing unsound banking practices.

Damage to Public Confidence. The Board also has determined that the proposed activities are not likely to damage public confidence in Applicants' subsidiary banks. First, the Board notes that damage to the reputation of affiliated banks is most likely to occur if the underwriting subsidiaries or customers who buy securities from them suffer losses. As explained above, the risk of loss on the kinds of securities that the underwriting industry will underwrite or deal in is carefully circumscribed. Also as explained above, under this proposal as approved by the Board, there are strict barriers between the underwriting subsidiaries and the affiliated banks, so that neither Applicants nor their subsidiary banks are responsible for any losses suffered by the underwriting subsidiaries.

Finally, in order to reduce further the association in the public mind between the bank holding company and its underwriting subsidiary and to prevent the direct or indirect involvement by the holding company in the ineligible activity approved only for underwriting subsidiary, the Board requires that each underwriting subsidiary provide to each of its customers a special disclosure statement describing the difference between the underwriting subsidiary and its banking affiliates and pointing out that the obligations of the underwriting subsidiary are not obligations of an affiliate bank and that the bank is not responsible for securities sold by the subsidiary. The statement should also disclose that an affiliated bank may be a lender to an issuer of ineligible securities underwritten or dealt in by the subsidiary and refer the customer to relevant disclosure documents for details. The Board notes that the Federal Deposit Insurance Corporation has recently proposed to require such disclosure in the case of affiliates of nonmember banks (52 *Federal Register 11,492, 11,497* (April 9, 1987)) and that Citicorp has indicated it proposes to provide a similar disclosure statement.

In the Board's view, the underwriting subsidiary should also disclose any material lending relationship between the issuer and a bank or lending affiliate of that subsidiary, as required

under the securities laws, and in every case whether the proceeds of that issue will be used to repay outstanding indebtedness to affiliates. In this regard, the Board notes that Citicorp, for example, recognizes that there should be extensive disclosure in the offering documents of any interest of an affiliated bank related to securities underwritten by CSI.[82]

The Board also requires that each underwriting subsidiary and any affiliated bank or thrift institution not engage in advertising or enter into an agreement stating or suggesting that an affiliated bank or thrift institution is responsible for the underwriting subsidiary's obligations. Applicants have each agreed to this limitation and certain other limits related to bank safety and soundness that are contained in the proposed section 23B of the Federal Reserve Act.[83]

To guard further against possible erosion of the public confidence in affiliated banks, no bank or thrift affiliate should act as agent for, or engage in marketing activities on behalf of, an underwriting subsidiary. The Board notes that Citicorp and Morgan have voluntarily agreed to such restrictions. In this regard, prospectuses and sales literature relating to securities underwritten or traded by the underwriting subsidiaries may not be distributed by bank or thrift affiliates; nor should any such literature be made available to the public at any offices of any such affiliate, unless specifically requested by a customer. (*See* 12 C.F.R. 225.125(h) regarding similar limitations on certain investment advisory activities of bank holding companies with respect to investment companies.) Additionally, affiliated banks or thrift institutions may not express an opinion with respect to the advisability of the purchase of ineligible securities underwritten or dealt in by the underwriting subsidiary, unless

82 Morgan and Bankers Trust object to these conditions on the grounds that similar types of disclosures are required under the federal securities laws. In the Board's view, however, specific articulation of these disclosure requirements as a condition of the approval of these applications will help assure that public confidence in the subsidiary banks will not be impaired.

83 *See* S. 2851, 98th Cong., 2d Sess. (1984), 130 *Cong. Rec.* S 11162, S 11166-67 (September 13, 1984).

the bank or thrift affiliate notifies the customer that its affiliated underwriting subsidiary is underwriting or making a market in the security.

Conflicts of Interest. In determining whether the proposed underwriting and dealing activities, as limited above, are a proper incident to banking, the Board also has condsidered whether the activities would result in conflicts of interest. Given that the proposed activities would not be a substantial activity of the underwriting subsidiaries, the fact that banks have engaged in substantially similar activities without giving rise to significant conflicts, and the limitations on the activity as discussed below, the Board believes that any potential conflicts arising from the proposal are manageable and would not be significant.

At the outset, there are, in the Board's view, certain factors that limit the potential conflicts of interest that can reasonably be expected as a result of these proposals. First, as explained above, the limited underwriting and dealing operations in municipal revenue bonds, private mortgage-backed securities, and commercial paper would be performed by separate subsidiaries that are substantially insulated from the operations of the affiliated banks. Second, although to some extent the potential for conflicts of interest exists in connection with permissible securities and lending activities presently engaged in by member banks, there is no evidence that bank underwriting of eligible securities over the past 50 years has produced serious conflicts of interest or other abuses or encouraged imprudent lending practices.[84] Because the proposed activities involve securities that are substantially similar to those presently underwritten and dealt in by banks, the Board believes that the potential for

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84 *See* Federal Reserve Board Staff Study, Commercial Bank Private Placement Activities 64-65 (1977); U.S. Department of the Treasury, Public Policy Aspects of Bank Securities Activities 34 (1975); S. Rep. No. 560, 98th Cong., 2d Sess. 15-16 (1984); *Moratorium Legislation and Financial Institutions Deregulation: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. 192 (1983) (statement of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System).

significant or new conflicts of interest with respect to the proposed ineligible securities would be manageable.

In this regard, the Board notes that in approving proposed legislation to allow bank holding companies to underwrite municipal revenue bonds, the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate relied on the similarity of the activity to bank eligible underwriting activity and the fact that banks have competed in the activity "safely and fairly for more than 50 years."[85]

The Board notes that, in the case of municipal revenue bonds, the fact that the issuer is a public entity makes potential conflicts less likely since these entities generally do not rely on bank lending for most of their funding. Similarly, issuers of securities backed by mortgages on 1-4 family residences do not rely significantly on bank funding.[86] Moreover, as the Board noted in approving commercial paper agency and principal activities in *Bankers Trust* and *Chase*, serving as a dealer in commercial paper is very similar in function to that of a lead bank in arranging loan participations or syndications, an operation that banks have traditionally performed. There is no evidence that banks' loan participation activities have produced serious conflicts of interest. Finally, while these general factors clearly reduce the potential for conflicts of interest, the Board believes that certain additional limitations, similar to those applied in the *Bankers Trust* and *Chase* decisions, are appropriate.

Credit to Purchasers of Securities. Protestants allege that Applicants' subsidiary banks may be encouraged to make imprudent loans to depositors for the purchase of securities underwritten by their affiliates. The Board notes that the possible temptation to extend credit for such purchases was a major concern leading to the enactment of the Glass-Steagall Act and that preserving the soundness and impartiality of credit granting is a major concern of the Board and other bank regulators under the banking laws. In order to address these concerns, the Board

85 S. Rep. No. 560, 98th Cong., 2d Sess. 15 (1984).

86 *See Hearings on S. 2181*, at 1612 (statement of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System).

believes that it is appropriate to require that no lending affiliate of the underwriting subsidiary may extend credit to a customer that is secured by, or for the purpose of purchasing, any ineligible security that the subsidiary underwrites during the course of the underwriting or for the purpose of purchasing from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market.[87] The Board notes Citicorp proposed a substantially similar limitation in connection with CSI's underwriting activities.

Credit to Issuers of Securities. The protestants also assert that a related conflict may also arise when Applicants' bank affiliates extend credit to issuers of securities underwritten or dealt in by the underwriting subsidiaries. It is argued that banks might be tempted to make unwise loans to improve the financial condition of companies whose securities are underwritten or dealt in by an affiliated underwriting subsidiary, either to assist in the marketing of the securities or to prevent the customers of the underwriting subsidiary from incurring losses on securities sold by the subsidiary. In order to assure that this conflict does not arise, the Board believes that neither Applicants nor any of their subsidiaries may make loans to issuers of ineligible securities underwritten by the underwriting subsidiaries for the purpose of the payment of principal and interest on such securities. To assure compliance with the foregoing limitation, any lines of credit extended by any lending subsidiary of Applicants to an issuer of ineligible securities underwritten by the underwriting subsidiaries must be for a documented special purpose, or have substantial participation by other lenders, and have substantially different timing, terms, conditions, and maturities from the ineligible securities being underwritten.

Applicants must adopt appropriate procedures, including maintenance of necessary documentary records, to assure that any extensions of credit by Applicants or any of their subsidi-

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87 This limitation extends to credit to all customers of the lending affiliates, including brokers, dealers, and unaffiliated banks, but does not include lending to a broker-dealer for the purchase of securities where an affiliated bank is the clearing bank for such broker-dealer.

aries to the issuer of ineligible securities underwritten or dealt in by the underwriting subsidiary are on an arm's length basis for purposes other than the payment of principal or interest on ineligible securities underwritten or dealt in by the securities subsidiaries. An extension of credit is considered to be on an arm's length basis if the terms and conditions are substantially the same as those prevailing at the time for comparable transactions with issuers whose securities are not underwritten or dealt in by the underwriting subsidiaries.

In addition, the Board also believes that, to the extent the creditworthiness of securities sold by the underwriting subsidiaries depends on the existence of explicit financial backing of the issuer, that backing should be supplied by lenders unaffiliated with Applicants. Thus, the Board believes it appropriate to require that neither Applicants nor any of their subsidiaries issue or enter into a standby letter of credit, asset purchase agreement, indemnity, insurance, or other facility that might be viewed as enhancing the creditworthiness or marketability of ineligible securities underwritten, placed or dealt in by the underwriting subsidiaries. This limitation will further assure that the proposed activities do not encourage less than sound credit practices. For example, without such a prohibition, an affiliated bank might be tempted to provide a letter of credit to support a commercial paper issue that would otherwise not be of prime quality in an effort to make the issue marketable.

The Board believes that the above requirements relating to credit extensions to issuers should also apply to extensions of credit to parties that will be major users of the projects that are financed by industrial revenue bonds underwritten by the underwriting subsidiary. This restriction will avoid the potential conflict that a bank may be tempted to make imprudent loans to those who will benefit from a particular industrial revenue bond project in order to ensure the success of the project being financed.

Applicants generally oppose any broad restriction on the provision of credit support by affiliated banks to issuers whose securities are sold by the underwriting subsidiaries. Applicants contend that banks currently provide letters of credit and simi-

lar facilities to issuers of municipal securities underwritten by the bank. Applicants also argue that economic reality would deter preferential lending in support of an underwriting subsidiary's activity because the potential exposure to the bank on an unsound loan would be greater than the underwriting and trading profits to be gained by the subsidiary.

However, the Board believes that the risk that a bank's credit judgment may be impaired by the existence of an investment banking relationship between a borrower and the bank's affiliate is one of the fundamental hazards at which the Glass-Steagall Act was aimed and is a significant consideration under the standards of section 4(c)(8) of the BHC Act, which are designed to maintain impartiality in the credit-granting process and thereby promote public confidence in banking organizations. A similar restriction was relied on by the Board in the *Bankers Trust* and *Chase* decisions.

Credit and Advances to Underwriting Subsidiaries. The protestants also assert that Applicants' subsidiary banks may be tempted to make imprudent extensions of credit or other investments to support the underwriting subsidiaries if they encounter financial difficulties. This conflict is inherent in transactions between banks and their affiliates generally and is addressed by section 23A of the Federal Reserve Act. (12 U.S.C. § 371c(c)(1)). That provision limits extensions of credit by a bank to its nonbank affiliates, as well as asset purchases from an affiliate, to 10 percent of the bank's capital and requires that any extensions of credit be collateralized (*e.g.*, 110 percent of the extension of credit if the collateral is composed of revenue bonds). Section 23A also prohibits a bank from purchasing low quality assets or accepting them as collateral. Section 23A thus imposes limits on the techniques that might be used to transfer funds of an affiliated bank to an underwriting subsidiary. Applicants have also agreed to comply with certain of the limits contained in the proposed section 23B of the Federal Reserve Act.[88] These limitations require that all purchases and sales of assets between a bank affiliate of Applicants and the underwrit-

88 *See* S. 790, 100th Cong., 1st Sess. § 102(a) (1987), 133 Cong. Rec. S. 4061, S. 4063 (March 27, 1987).

ing subsidiaries, including transactions with third parties if the underwriting subsidiaries are a participant or have a financial interest in the third party or act as agent or broker or receive a fee for their services, be at arm's length and on terms no less stringent than those applicable to unrelated third parties.[89]

An additional potential conflict that might occur is the possibility that Applicants' subsidiary banks might make unwarranted purchases of securities underwritten or dealt in by the underwriting subsidiaries in order to assist the subsidiaries' marketing efforts or to prevent losses by the subsidiaries. The possibility that such securities might be dumped into the bank's inventory was a major concern underlying the Glass-Steagall Act. That such transactions represent a potential adverse effect is also evidenced by the fact that legislation recently considered by Congress contained a provision (the proposed new section 23B of the Federal Reserve Act) expressly dealing with this possibility in connection with eligible underwriting conducted directly by banks. Applicants maintain that the possibility of this adverse effect is mitigated on the basis that the securities being underwritten by the underwriting subsidiaries are eligible investments for banks and by existing regulatory requirements. Applicants point in particular to rules of the NASD, which prohibit a member engaged in a fixed price offering of securities (other than U.S. government or municipal securities) from selling such securities or placing them with an affiliate during the course of the underwriting.[90]

While the underwriting subsidiaries would be NASD members and subject to this rule against sales to affiliates, the rule does not apply to the offering of municipal securities, which is likely to be an important part of the subsidiaries' ineligible op-

89 In particular, the transactions must be on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies or, in the absence of comparable transactions, those terms and circumstances that in good faith would be offered to, or would apply to, nonaffiliated companies.

90 Article II, § 1(m); Article III, § 36, NASD Rules of Fair Practice, NASD Manual (March 1985), ¶ 201-2196.

erations, and does not appear to address possible sales of unsold securities to an affiliate at the termination of the underwriting syndicate. In addition, although the limitations in section 23A would also be applicable in this situation, section 23A does not reach all inter-affiliate transactions.[91]

Accordingly, the Board believes that, in view of the significance of this concern, and a record indicating a basis for the Board's concern in these cases, Applicants and their subsidiaries (other than the underwriting subsidiaries) should not purchase, as principal, ineligible securities underwritten by the underwriting subsidiary during the underwriting period and for 60 days after termination of the underwriting and should not purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market. The Board believes this requirement is essential to address the potential for conflicts of interest that could have a detrimental impact on the financial resources of the affiliates of the underwriting subsidiaries.

Biased Investment Advice. Protestants also raise concerns relating to whether the proposals will impair Applicants' obligation to provide unbiased investment advice to trust department customers.[92] Applicants object to a proposed condition that would address this concern by precluding Applicants and their subsidiaries from purchasing as trustee or in any other fiduciary capacity ineligible securities underwritten or dealt in by their underwriting subsidiaries or from recommending to their customers the purchase of such securities.

Applicants note that banks and broker-dealers are already subject to extensive restrictions against self-dealing under the securities laws and banking regulation as well as under common law fiduciary requirements and that an absolute prohibition is

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91 Under section 23A, a bank affiliate could invest up to 10 percent of its capital in securities underwritten by an affiliate. In addition, section 23A does not apply in the case of assets having a readily identifiable and publicly available market quotation. Finally, section 23A does not apply to purchases by the parent holding company or other nonbank affiliates of securities underwritten by the underwriting subsidiary.

92 *See Bankers Trust I*, 468 U.S. at 146-147; *ICI I*, 401 U.S. at 633.

unnecessary given these restrictions and may not in fact be in the best interests of the bank's customers. In accordance with these standards, a bank or other investment adviser must disclose to an advisory customer any interest of its affiliate as underwriter or market maker in the securities being purchased or recommended and may not purchase such securities for a customer unless the purchases are specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered. For example, OCC Trust Banking Circular 19 generally prohibits national banks from purchasing in a fiduciary capacity securities underwritten by a commercial department of the bank either individually or as a syndicate member during the period of any underwriting or selling syndicate and creates a presumption that such purchases made for a period of 60 days after termination of the syndicate are also unlawful, except where authorized under the provisions of the governing trust instrument as noted above.

In addition, under fiduciary principles, affiliated banks may not express opinions about the advisability of investing in ineligible securities underwritten by the bank or its affiliates without disclosure. This limitation, which the Board believes should be explicitly applied to the underwriting subsidiaries, will assure that less than objective advice will not be provided by Applicants.[93] Moreover, each Applicant has committed that any dealings with the underwriting subsidiaries (or a company in which the subsidiary has an interest or for which it is acting as agent or underwriter) will be conducted on an arm's length basis and will

93 Protestants have also raised the possibility that Applicants might not provide impartial advice to customers about the best method of obtaining funds or might not provide sound investment advice to correspondent banks. Under the terms of the Board's approval, the underwriting subsidiaries here would be insulated from the lending and other departments of affiliated banks and, to a large extent, the issuers of the ineligible securities that will be sold by the underwriting subsidiaries are financially sophisticated and are able to make their own assessment about various financing methods. Likewise, correspondent banks have significant expertise in investing in municipal and mortgage-related securities and have traditionally purchased commercial paper for their own account.

not involve preferential terms or conditions. As discussed above, each Applicant will also provide customers with a specific disclosure statement describing the difference between affiliated banks and the underwriting subsidiary. The Board believes these disclosure and fiduciary requirements, if followed by the bank holding company and its bank, thrift, investment adviser and trust company subsidiaries, are sufficient to address concerns regarding conflicts of interest involving bank affiliates acting in a fiduciary capacity.

Securities Issued by Affiliates. An additional concern has been raised regarding the potential conflicts that might arise if an underwriting subsidiary underwrites or deals in securities of affiliated entities, particularly those that may be experiencing financial difficulties.

In the Board's view, the incentives for a conflict of interest to arise in underwriting and dealing in an affiliate's securities could be substantial, depending on factors such as the extent, regularity, or purpose of such underwriting and dealing. The Board notes that Congressional concern over bank securities affiliates' underwriting and making markets in the securities issued by their bank affiliates was cited as one of the principal reasons for the Glass-Steagall Act. *ICI II*, 450 U.S. at 61-62. Specifically, where the underwriting subsidiary offers securities representing interests in pools of assets created by its affiliates, the temptation exists that the affiliates' least creditworthy assets would be securitized.

Applicants maintain that investment banking firms that are part of an integrated holding company organization are subject to the same conflict in selling their affiliates' securities and that this conflict has been addressed by the disclosure requirements under the securities laws and by NASD rules. The Board is unable to conclude on the basis of the record of these applications, however, that these requirements alone would be adequate. First, the fact that investment banking firms that are not affiliated with banks face this kind of conflict in underwriting affiliates' obligations is not probative here. These firms are not subject to the public benefits test in section 4(c)(8), which imposes an affirmative duty on the Board to consider potential

conflicts of interest associated with bank holding companies' nonbanking activities.

Second, the Board's concern in this case is not limited to the protection of investors. The reputation of affiliated banks could be damaged if the underwriting subsidiary sells securities issued by its affiliates to the public and those securities subsequently deteriorate in quality. Nor is it clear that disclosure requirements alone would be adequate, since the underwriting subsidiary may have an incentive to be less objective in evaluating creditworthiness and in describing all material facts when the subsidiary seeks to market obligations of entities under common control with it. The requirement of an unaffiliated underwriter will tend to ensure that an independent and impartial credit judgment will be made in connection with securities issued by a banking organization.

On the basis of the foregoing, the Board requires, as a condition to its Order in order to avoid this potential conflict, that an underwriting subsidiary may not underwrite or deal in any ineligible securities issued by its affiliates or representing interests in, or secured by, obligations originated or sponsored by its affiliates (except for grantor trusts or special purpose corporations created to facilitate underwriting of securities backed by residential mortgages originated by a nonaffiliated lender).

Securities to Repay Loans. The final category of potential conflicts of interest cited by protestants involves possible harm to the interests of those who purchase securities sold by the underwriting subsidiaries. Protestants contend that Applicants might encourage issuers to issue securities, the proceeds of which will be used to repay loans made by affiliated banks.

The Board believes that incentives to convert a risky loan held by an affiliate to a security sold to the public by the underwriting subsidiary are minimized by the condition in this Order that precludes underwriting or dealing in ineligible securities issued by affiliates, and by the economic disincentive for a bank holding company to jeopardize the reputation of its underwriting subsidiary as well as of its bank and other lending subsidiaries by engaging in underwriting for this purpose. The Board further believes that this abuse is made unlikely by the require-

ments, explained earlier in this Order, that the underwriting subsidiary should disclose to purchasers any material lending relationship between the issuer and a bank or lending affiliate of the underwriting subsidiary as required under the securities laws and in every case whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates.

Finally, the Board also notes that the ineligible securities underwritten and dealt in by the underwriting subsidiaries will be rated by independent rating services. The necessity for objective credit ratings makes it extremely difficult for issuers experiencing financial difficulties to issue securities that will be accepted by the market. Accordingly, subject to the foregoing limitations, the Board believes that the proposal does not pose conflicts of interest sufficient to outweigh the public benefits of the proposal.

Unfair Competition. The Board has also considered protestants' contention that the proposed underwriting affiliates would have unfair competitive advantages over other underwriters and dealers that are not affiliated with banks. Protestants allege that Applicants would enjoy unfair advantages in, for example, the rates they would pay for funding; access to the credit files of banking affiliates to obtain information useful in marketing their services to issuers; and tax advantages available only to banks that hold municipal securities. The Board finds that this limited proposal would not result in unfair competition for the following reasons.

Access to Low-Cost Funds. With respect to protestants' funding claim, there is no evidence that Applicants' underwriting subsidiaries would, by reason of their affiliation with federally insured banks, enjoy access to lower cost funds than their competitors that are not affiliated with banks.[94] Funding for the underwriting subsidiaries would be provided by their parent holding companies, which are not banks. A corporation's funding costs are a function of a variety of economic factors, includ-

94 The Board notes that banks do not dominate the markets for bank-eligible securities, suggesting that the alleged funding advantages for banks are not a significant competitive factor.

ing size, capital and earnings. While the regulatory framework under which a corporation operates is a factor that may affect cost of funds, the same bank regulatory structure that provides deposit insurance imposes restraints and important costs on the operation of banks and their affiliates that are not imposed on other corporations. In addition, rates paid by Applicants and other bank holding companies on their commercial paper have generally been the same as those paid by corporations of similar size and credit ratings.

As noted above, the underwriting subsidiaries would be corporations legally separate and apart from Applicants' banking affiliates. Accordingly, the underwriting subsidiaries would not obtain funding directly through federally insured deposits or the Federal Reserve's discount window, which is available to depository institutions. Moreover, the Board does not believe that there would be a strong likelihood that insured deposits or the proceeds of discount window loans could be transferred from affiliated banks to the underwriting subsidiaries, in view of the lending limitations and collateral requirements of section 23A of the Federal Reserve Act, and the fact that any other inter-affiliate transactions not subject to section 23A must be conducted on an arm's length basis.

In any event, as the Board noted in *BankAmerica/Schwab*, the legislative history of section 4(c)(8) of the Act indicates that the term "unfair competition" was intended to refer to unfair or unethical business conduct under the law, and not to disparities established by existing federal regulation of providers of financial services.[95] Accordingly, for the reasons set out in *BankAmerica/Schwab*, even if the underwriting subsidiaries might obtain some funding advantage by reason of their affiliation with Applicants, the Board finds that such advantage is not unfair competition within the meaning of section 4(c)(8) of the Act.

Access to Confidential Information. The Board has also considered the allegation that unfair competition would result from sharing of confidential information between the under-

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95 69 FEDERAL RESERVE BULLETIN 105, 111 (1983), affirmed by the Supreme Court in *Schwab*.

writing subsidiaries and their affiliates, such as granting the underwriting subsidiaries access to the credit files of their affiliates to determine the financial needs of issuers and potential issuers to enable the subsidiaries to offer their services to issuers in advance of competitors.

To address the possibility of potential unfair competition or conflicts arising as a result of information sharing, Applicants state that they will voluntarily establish appropriate "Chinese walls" to prevent information acquired by the organization in one capacity from being improperly used in another area.

However, the Board does not believe that these commitments are sufficiently strong to assure that this conflict will not occur. Accordingly, as a condition of the Board's approval of these applications, no lending affiliate of the underwriting subsidiaries may disclose to the underwriting subsidiaries any nonpublic customer information consisting of an evaluation of the creditworthiness of an issuer or other customer of the underwriting subsidiary, other than as required by securities laws.

With respect to the potential for adverse effects from the disclosure of confidential information held by an underwriting subsidiary to its affiliates, the Board notes that trading on inside information about issuers would violate the federal securities laws. Moreover, the incentive to gain access to confidential information possessed by the underwriting subsidiary is reduced by the prohibition discussed above on the purchase by any affiliate as principal or trustee from the underwriting subsidiary of securities distributed by the subsidiary. Nevertheless, the Board believes it appropriate to require that the officers or employees of an underwriting subsidiary may not disclose nonpublic customer information consisting of an evaluation of the creditworthiness of an issuer or other customer of the underwriting subsidiary to its affiliates.[96]

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96 The Board notes that explicit tying of services offered by Applicants' subsidiary banks and by the underwriting subsidiaries is prohibited by section 106 of the Bank Holding Company Act Amendments of 1970. 12 U.S.C. §§ 1972-78.

Tax Treatment. Finally, the Board has considered protestants' argument that Applicants' subsidiary banks receive different tax treatment than general corporations with regard to interest expense for carrying municipal securities. However, the Board finds that banks' differing tax treatment does not constitute an unfair competitive practice. First, the Tax Reform Act of 1986 has significantly reduced the tax advantages available to banks with respect to interest expense for municipal securities.[97] The underwriting subsidiaries are not banks and would not have the benefit of tax provisions applicable to banks. In addition, under this Order the underwriting subsidiaries may not sell ineligible municipal securities to affiliates during the underwriting period and there is no evidence that Applicants intend to engage in transactions to place the underwriting subsidiaries' eligible municipal securities temporarily with affiliated banks to obtain any tax advantage.[98]

In any event, banks' tax treatment, like their coverage by deposit insurance, is a result of federal regulation, rather than of unethical or unfair business practice. As the Board specifically noted in *BankAmerica/Schwab*, any competitive advantage accruing from the favorable tax treatment accorded bank municipal securities dealers does not represent the type of adverse effect about which the Act was concerned.[99]

Undue Concentration of Resources or Decreased Competition. The Board has carefully considered the possibility that these proposals would result in an undue concentration of resources, in view of the size of Applicants and the concern expressed in the BHC Act regarding the concentration of control

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97 Pub. L. No. 99-514, § 902 (Oct. 22, 1986).

98 The possibility of such tandem operations occurring is also minimized by the fact that there will be no interlocking directors, management or employees among the underwriting subsidiaries and bank or thrift affiliates.

99 69 FEDERAL RESERVE BULLETIN at 111.

over credit resources.[100] The Board has also considered the contentions of protestant Salomon Brothers and others that the existence of severe limitations on banking institutions' securities activities prevents a concentration of resources and promotes competitive innovation between banking institutions and investment banking firms. The Board finds that these proposals are not likely to lead to undue concentration of resources or decreased competition under the facts and circumstances of and subject to the limitations imposed on the activities herein.

Applicants seek an expansion of authority to underwrite and deal in limited kinds of securities on a *de novo* basis and these proposals do not involve any combination of existing competitors. Thus, the proposals would not eliminate any existing provider of the services involved, but would add the underwriting subsidiaries as new competitors. Addition of new competitors may reasonably be expected to increase competition and promote deconcentration in the underwriting market for the types of ineligible securities proposed. The likelihood that these proposals would result in concentrations of resources is further reduced by the fact that in order to comply with the restrictions of section 20, the volume of ineligible revenue bonds and ineligible mortgage-backed securities underwritten by the underwriting subsidiaries in any one year will not exceed 5 percent of the total amount of each such kind of security underwritten domestically by all firms during the previous calendar year. Similarly, the volume of such ineligible securities held by the underwriting subsidiaries as a result of their secondary market activity may not exceed 5 percent of the total amount of that type of security underwritten domestically by all firms during the previous calendar year. Similar market limits apply to commercial paper activities.

Finally, the Board notes that, as authorized by section 16 of the Glass-Steagall Act, banks underwrite and deal in eligible securities without any market size limitation, and this authority

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100 *See* H.R. Conf. Rep. No. 1747, 91st Cong., 2d Sess. 17 (1970) (Statement of the Managers on the Part of the House).

has not led to adverse effects with respect to concentration of resources. In fact, the markets for bank eligible securities are markedly less concentrated that those for ineligible securities.

Financial Factors. In evaluating these applications, the Board has carefully considered the financial resources of each Applicant, including its capital position, and the effect on these resources of the proposed activities. The Board has also considered the comments of the SIA and several other protestants that, after the initial capitalization of the underwriting subsidiaries, Applicants should be precluded from providing any additional capital support to the subsidiaries.

The Board has indicated on previous occasions that a bank holding company should be a source of financial strength to its subsidiaries, in particular to its banking subsidiaries, and that the Board will evaluate an application for expanding nonbanking activity with this consideration in mind. The Board has required holding companies seeking approval for new activities to have the financial resources to capitalize the nonbanking entity in accordance with industry standards generally and the risk factors involved in the activity in particular, with the aims of assuring, to the extent feasible, that the new activity can support itself on a stand-alone basis, while at the same time maintaining the bank holding company's ability to serve as a source of financial strength to its subsidiary banks.[101]

In these cases, the Board believes it is appropriate to exclude the capital (and related assets) of the underwriting subsidiaries from the consolidated capital that Applicants are required to maintain under the Board's Capital Adequacy Guidelines. In the Board's view, this exclusion of the capital of the underwriting subsidiaries is consistent with the preservation of the bank holding company's resources for subsidiary banks, and, in

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101 *See* Statement of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, Before the Subcomm. on Commerce and Monetary Affairs of the Comm. on Government Operations. U.S. House of Representatives (June 11, 1986), *reprinted* in 72 FEDERAL RESERVE BULLETIN 541, 545 (1986); *State Bond and Mortgage Company*, 71 FEDERAL RESERVE BULLETIN 722 (1985).

the Board's view, a general prohibition against additional funding of the underwriting subsidiary by the parent holding company is unnecessary, provided that in each specific case the provision of funds to the subsidiary is not detrimental to subsidiary banks.

The Board further notes that the underwriting subsidiaries will be subject to a separate regulatory capital requirement—the SEC's net capital rule. Accordingly, the Board finds the proposed capitalization of each of the underwriting subsidiaries in these cases will be adequate under the generally accepted norms for companies engaged in similar activities. The Board will monitor the development and risk profiles of the underwriting subsidiaries in order to determine if their capital is adequate.

C. Pending Legislation.

In its consideration of this case, the Board has noted that on March 27, 1987, the United States Senate passed legislation that, if enacted, would prohibit Board approval between March 6, 1987 and March 1, 1988, of any application, such as the present proposals, that would permit a bank holding company to engage in the underwriting or public sale of securities on the basis that it was not "engaged principally" in such activity within the meaning of section 20 of the Glass-Steagall Act.[102] This prohibition would not apply to applications pending prior to the date of enactment of the legislation if the Board delays the effective date of the decision until the expiration of the moratorium.

This moratorium legislation, however, has not yet been enacted into law. Accordingly, and as the Board stated in the *Chase* decision, the Board is required as provided in existing law to act on these applications within mandated time periods and in accordance with the applications processing schedule prescribed by Regulation Y. Moreover, the applications, as noted, comply with existing law under the framework established by the Board in this Order.

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102 Competitive Equality Banking Act of 1987 (S. 790), 100th Cong., 1st Sess. § 201; 133 *Cong. Rec.* S. 4061, S. 4067 (March 27, 1987).

While the Board believes it must proceed to reach a decision on the applications, the Board calls to Applicants' attention that they may be required by subsequent Congressional action to cease their ineligible underwriting and dealing activities approved in this Order. The Board retains jurisdiction over the applications to act to carry out the requirements of any legislation adopted by Congress that would affect Applicants' conduct of underwriting and dealing activities under this Order and the Bank Holding Company Act.

Conclusion

In sum, the Board finds that these proposals, as limited by this Order, are consistent with section 20 of the Glass-Steagall Act and may reasonably be expected to result in public benefits that outweigh possible adverse effects. Accordingly, the Board finds that Applicants may conduct the proposed activities to the extent and in the manner described in this Order consistent with section 20 of the Glass-Steagall Act and section 4(c)(8) of the BHC Act. The Board's approval of these applications extends only to the activities conducted within the limitations of this Order as summarized below (and subject to the gross revenue and market share limitations discussed above), and underwriting or dealing in ineligible securities in any manner other than as described below and in this Order[103] is not within the scope of the Board's approval and is not authorized for the underwriting subsidiaries:

A. Types of Securities to be Underwritten

1. The underwriting subsidiaries shall limit their underwriting and dealing in ineligible securities to the following:

103 The underwriting subsidiaries may also provide services that are necessary incidents to these approved activities. The incidental services should be taken into account in computing the gross revenue and market share limits on the underwriting subsidiaries' ineligible underwriting and dealing activities, to the extent such limits apply to particular incidental activities.

a. *Municipal revenue bonds* that are rated as investment quality (*i.e.*, in one of the top four categories) by a nationally recognized rating agency, except that industrial development bonds in these categories shall be limited to "public ownership" industrial development bonds (*i.e.*, those tax exempt bonds where the issuer, or the governmental unit on behalf of which the bonds are issued, is the sole owner, for federal income tax purposes, of the financed facility (such as airports and mass commuting facilities)).

b. *Mortgage-related securities* (obligations secured by or representing an interest in 1-4 family residential real estate), rated as investment quality (*i.e.*, in one of the top 4 categories) by a nationally recognized rating agency.

c. *Commercial Paper* that is exempt from the registration and prospectus requirements of the S.E.C. pursuant to the Securities Act of 1933 and that is short term, of prime quality, and issued in denominations no smaller than $100,000.

B. Capital Investment

2. Each Applicant's investment in an underwriting subsidiary and the assets of the underwriting subsidiary shall be excluded in determining the holding company's consolidated primary capital under the Board's Capital Adequacy Guidelines.

C. Capital Adequacy

3. The underwriting subsidiary shall maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms.

4. Applicants shall submit quarterly to the Federal Reserve Bank of New York FOCUS reports filed with the NASD or other self-regulatory organizations, and detailed information breaking down the underwriting subsidiaries' business with respect to eligible and ineligible securities, in order to permit

monitoring of the underwriting subsidiaries' compliance with the provisions of this Order.

D. Credit Extensions by Lending Affiliates to Customers of the Underwriting Subsidiary

5. No Applicant or subsidiary shall extend credit, issue or enter into a stand-by letter of credit, asset purchase agreement, indemnity, insurance or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten by an affiliated underwriting subsidiary.

6. No lending affiliate of an underwriting subsidiary shall knowingly extend credit to a customer secured by, or for the purpose of purchasing, any ineligible security that an affiliated underwriting subsidiary underwrites during the period of the underwriting, or to purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market. This limitation extends to all customers of lending affiliates, including brokers-dealers, and unaffiliated banks, but does not include lending to a broker-dealer for the purchase of securities where an affiliated bank is the clearing bank for such broker-dealer.

7. No Applicant or any of its subsidiaries may make loans to issuers of ineligible securities underwritten by an affiliated underwriting subsidiary for the purpose of the payment of principal and interest on such securities. To assure compliance with the foregoing, any credit lines extended to an issuer by any lending subsidiary of the bank holding company shall provide for substantially different timing, terms, conditions and maturities from the ineligible securities being underwritten. It would be clear, for example, that a credit has substantially different terms and timing if it is for a documented special purpose (other than the payment of principal and interest) or there is substantial participation by other lenders.

8. Each Applicant shall adopt appropriate procedures, including maintenance of necessary documentary records, to assure that any extensions of credit to issuers of ineligible securities underwritten or dealt in by an underwriting subsidiary are on an arm's length basis for purposes other than payment of principal and interest on the issuer's ineligible securities being underwritten or dealt in by the subsidiary. An extension of credit is considered to be on an arm's length basis if the terms and conditions are substantially the same as those prevailing at the time for comparable transactions with issuers whose securities are not underwritten or dealt in by the underwriting subsidiaries.

9. The requirements relating to credit extensions to issuers noted in paragraphs 5-8 above shall also apply to extensions of credit to parties that are major users of projects that are financed by industrial revenue bonds.

E. Limitations to Maintain Separateness of an Underwriting Affiliate's Activity

10. There will be no officer, director, or employee interlocks between an underwriting subsidiary and any of the holding company's bank or thrift subsidiaries. The underwriting subsidiary will have separate offices from any affiliated bank.

F. Disclosure by the Underwriting Subsidiary

11. An underwriting subsidiary will provide each of its customers with a special disclosure statement describing the difference between the underwriting subsidiary and its banking affiliates and pointing out an affiliated bank could be a lender to an issuer and referring the customer to the disclosure documents for details. The statement shall also indicate that the obligations of the underwriting subsidiary are not those of any affiliated bank and that the bank is not responsible for securities sold by the underwriting subsidiary. The underwriting subsidiary should disclose any material lending relationship between the issuer and a bank or lending affiliate of the underwriting subsidiary as required under the securities laws and in

every case whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates.

12. No underwriting subsidiary nor any affiliated bank or thrift institution will engage in advertising or enter into an agreement stating or suggesting that an affiliated bank is responsible in any way for the underwriting subsidiary's obligations.

13. No bank or thrift affiliate of the underwriting subsidiary will act as agent for, or engage in marketing activities on behalf of, the underwriting subsidiaries. In this regard, prospectuses and sales literature of an underwriting subsidiary may not be distributed by a bank or thrift affiliate; nor should any such literature be made available to the public at any offices of any such affiliate, unless specifically requested by a customer.

G. Investment Advice by Bank/Thrift Affiliates

14. An affiliated bank or thrift institution may not express an opinion with respect to the advisability of the purchase of ineligible securities underwritten or dealt in by an underwriting subsidiary unless the bank or thrift affiliate notifies the customer that its affiliated underwriting subsidiary is underwriting or making a market in the security.

H. Conflicts of Interest

15. No Applicant nor any of its subsidiaries, other than the underwriting subsidiary, shall purchase, as principal, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period, or shall purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market.

16. No Applicant nor any of its bank, thrift, or trust or investment advisory company subsidiaries shall purchase, as a

trustee or in any other fiduciary capacity, for accounts over which they have investment discretion ineligible securities

(i) underwritten by the underwriting subsidiary as lead underwriter or syndicate member during the period of any underwriting or selling syndicate, and for a period of 60 days after the termination thereof, and

(ii) from the underwriting subsidiary if it makes a market in that security, unless, in either case, such purchase is specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.

17. An underwriting subsidiary may not underwrite or deal in any ineligible securities issued by its affiliates or representing interests in, or secured by, obligations originated or sponsored by its affiliate (except for grantor trusts or special purpose corporations created to facilitate underwriting of securities backed by residential mortgages originated by a non-affiliated lender).

18. All purchases and sales of assets between bank (or thrift) affiliates and an underwriting subsidiary (or third parties in which the underwriting subsidiary is a participant or has a financial interest or acts as agent or broker or receives a fee for its services) will be at arm's length and on terms no less stringent than those applicable to unrelated third parties, and will not involve low-quality securities, as defined in section 23A of the Federal Reserve Act.

I. Limitations to Address Possible Unfair Competition

19. No lending affiliate of an underwriting subsidiary may disclose to the underwriting subsidiary any nonpublic customer information consisting of an evaluation of the creditworthiness of an issuer or other customer of the underwriting subsidiary (other than as required by securities laws and with the issuer's consent) and no officers or employees of the underwriting subsidiary may disclose such information to its affiliates.

J. Formation of Subsidiaries of an Underwriting Subsidiary to Engage in Underwriting and Dealing

20. Pursuant to Regulation Y, no corporate reorganization of an underwriting subsidiary, such as the establishment of subsidiaries of the underwriting subsidiary to conduct the activities, may be consummated without prior Board approval.

Because these proposals represent the first major entry of banking organizations into the field of underwriting and dealing in ineligible securities, the Board believes it appropriate to proceed cautiously and has established an extensive framework of prudential limitations to address conflicts of interest, unsound banking practices, and other adverse effects. After the underwriting subsidiaries have established a record of experience in the proposed activities, the Board may review the continued appropriateness of particular limitations. Similarly, the Board may from time to time, based upon experience with the activities, establish additional limitations on the conduct of the activities to ensure that the subsidiary's activities are consistent with safety and soundness, conflict of interest, and other considerations relevant under the BHC Act.

Based on the foregoing and other considerations reflected in the record, and as set forth in the Appendix, the Board finds that these proposals, as limited in this Order are consistent with section 4(c)(8) of the Bank Holding Company Act and section 20 of the Glass-Steagall Act, and may reasonably be expected to result in public benefits that outweigh possible adverse effects.[104] Accordingly, the Board finds that Citicorp, J.P. Mor-

104 The SIA has requested the Board to release data submitted by Applicants in connection with these proposals concerning the volume of sales and income derived from underwriting and dealing in eligible securities since 1982, and their projected volume and income to be derived from underwriting and dealing in ineligible securities. The Board has accorded this information confidential treatment since public disclosure of this data could significantly impair Applicants' competitive

gan and Bankers Trust may conduct the proposed activities to the extent and in the manner described in this Order and Appendix consistent with section 4(c)(8) of the BHC Act.

The Board's determination is subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of the holding companies or any of their subsidiaries as the Board finds necessary to ensure that the underwriting subsidiaries' activities are consistent with safety and soundness and conflict of interest considerations and to assure compliance with the provisions of the BHC Act and the Board's regulations and orders issued thereunder, or to prevent evasion thereof.

These transactions shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of New York, pursuant to delegated authority.

By order of the Board of Governors, effective April 30, 1987.

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position. The SIA states that disclosure of the data is necessary to ascertain the extent to which Applicants' capital will be at risk as a result of the proposals. The Board notes, however, that the underwriting and dealing activities of the underwriting subsidiaries in ineligible securities may not exceed 5 percent of the total market in such securities. Since these market limitations determine the maximum scope of the proposed activities and since market data are publicly available, release of the confidential data submitted by Applicants does not appear necessary. The additional information requested by the SIA is publicly available and involves the kinds of transactions with affiliates that are not permitted under this Order.

In addition, the Board does not believe this information is necessary for resolution of the other issues raised by the SIA. With respect to risk to Applicants' capital, the Board has required that Applicants may invest in the underwriting subsidiaries only to the extent that such funds would be in excess of the Board's capital requirements for bank holding companies and, as discussed above, the Board does not believe the potential for loss to Applicants or their other affiliates from the underwriting subsidiaries is substantial.

Voting for these actions: Governors Johnson, Seger, and Heller. Voting against these actions: Chairman Volcker and Governor Angell.

WILLIAM W. WILES
Secretary of the Board

[SEAL]

Dissenting Statement of Chairman Volcker and Governor Angell

We regret we are unable to join the majority in approving the pending applications.

The regret reflects the fact that, as a matter of policy, we support the idea that affiliates of bank holding companies underwrite and deal in commercial paper, municipal revenue bonds, and 1-4 family mortgage-related securities, the activities involved in the Board's decision.[1] Moreover, we agree generally with the nature of the limitations placed upon the activities in the Board decision, assuming the threshold question of their legality in the *particular form proposed* can be answered affirmatively.

Our point of difference involves precisely that question of law. Section 20 of the Glass-Steagall Act provides that no member bank may be affiliated with any corporation engaged principally in the underwriting of stocks, bonds, debentures, notes or other securities. We believe the plain words of the statute, read together with earlier Supreme Court and circuit court opinions, as we understand them, indicate that government securities are indeed "securities" within the meaning of section 20. Consequently, it appears to us that the applications approved today, as a matter of law, involve affiliations of member banks with corporations that are in fact not only "principally engaged" in dealing and underwriting in securities, but in fact would be

1 We have joined earlier decisions of the Board authorizing some of these activities in non-securities affiliates.

wholly engaged in such activities, thereby exceeding the authority of law.[2]

Our point is not merely one of legal formalisms. The interpretation adopted by the majority would appear to make feasible, as a matter of law if not Board policy, the affiliations of banks with some of the principal underwriting firms or investment houses of the country. Such a legal result, we feel, is inconsistent with the intent of Congress in passing the Glass-Steagall Act.

As the Board as a whole has repeatedly urged, the plain and desirable remedy to this legal and substantive morass is a fresh Congressional mandate. We urge the Congress to provide straightforwardly the authority for bank holding companies to conduct, with appropriate safeguards, the kinds of activities permitted by the Board in its decision, the practical import of which is confined to a relative handful of large bank holding companies with substantial government securities operations.

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2 Without elaborating on the legal debate reviewed in the Board's order, we wish to reiterate that we fully support earlier Board decisions allowing the underwriting and dealing of government securities to take place in an affiliate. Our point of disagreement is whether that authority can, in effect, be used to bootstrap securities activities that Congress clearly wished to restrain or prohibit.

Appendix A

Table of Contents

Appendix B

The Board issues the following statement setting forth in more detail its findings and analysis underlying certain of the Board's conclusions in its Order of April 30, 1987, regarding the applications of Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation, to engage in limited underwriting and dealing in certain securities proposed in the applications through wholly owned subsidiaries. The Appendix will address the Board's conclusion that the term "public sale" contained in section 20 of the Glass-Steagall Act covers dealing in securities. Section 20 provides that no member of the Federal Reserve System shall be affiliated with any corporation engaged principally in the "issue, flotation, underwriting, public sale, or distribution" of securities. 12 U.S.C. § 377.

The Board concludes that the term "public sale," as used in section 20 of the Glass-Steagall Act, covers the proposed dealing activities. The Board believes this result is consistent with the terms of section 20, the legislative history, the rationale of the Supreme Court's decision in *Securities Industry Association* v. *Board of Governors of the Federal Reserve System*, 468 U.S. 207 (1984) ("*Schwab*"), the Board's long-held view that dealing is covered by the term "public sale" in section 32 of the Glass-Steagall Act—a companion provision to section 20, and Congressional purposes underlying section 20.

In reaching this conclusion the Board has carefully considered the arguments of the Applicants, who contend that "dealing" is not covered by the terms "issue, flotation, underwriting, public sale, or distribution" as used in section 20. In support of this contention, the arguments are advanced that the term "public sale" should be read to refer to underwriting or initial distribution activity because other terms used in section 20 refer to underwriting or initial distributions of securities, that the word "public" used in public sale carries the connotation of a distribution, and that the legislative history would support a distinction between dealing and distributing.

Literally, the term "public sale" in section 20 is broad enough to encompass dealing in securities. In common industry usage, a "dealer" in securities "holds himself out as one engaged in buying and selling securities at a regular place of business"[1] and "sells securities to his customer which he has purchased or intends to purchase elsewhere or buys securities from his customer with a view to disposing of them elsewhere."[2] Thus, a dealer, acting for his own account, maintains an inventory of particular issues of securities in the secondary market—frequently acting as a market maker in these securities.

The term "sale", used in a commercial context, has been interpreted as referring to transactions in which a seller acting as principal transfers title to a buyer.[3] In the Board's view, since a dealer holds himself out to the public as being willing to buy and sell securities for his own account, the dealer can reasonably be viewed as engaging in the "public sale" of particular securities.

The legislative history indicates that Congress intended dealing in securities to be covered by section 20, the provision designed to require member banks to divorce their securities affiliates. In its 1933 report following hearings on the Glass bill, the Senate Banking Committee stated that it proposed to separate member banks from affiliates that devoted themselves not only to underwriting but also to "stock speculation" and

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1 2 L. Loss. *Securities Regulation* 1297 (2d ed. 1961).

2 SEC. *Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker* xiv-xvi (1936); reprinted in 2 L. Loss. *id.* at 1215-17.

3 *See Webster's Third New International Dictionary* (1961); *Black's Law Dictionary* 1200 (5th ed. 1979); U.C.C. § 2-106 (1978); *see also Gross* v. *Vogel* 81 A.D.2d 576, 437 N.Y.S.2d 431 (1981), and *E.F. Hutton* v. *Zaferson*, 509 S.W.2d 950, 952 (Texas 1974).

"maintaining a market for the banks' own stock."[4] Senator Glass was particularly critical of bank affiliates that "*dealt* in the stocks of the parent bank." 75 Cong. Rec. 9887 (1932) (emphasis added). In describing the activity of a bank securities affiliate to be divorced under the Act, Senator Walcott specifically noted that its business was to underwrite, purchase or sell various securities as they come along in the market.[5]

In *Schwab*, the Supreme Court interpreted the term "public sale" in section 20 as not applying to a discount broker that buys and sells securities solely upon the unsolicited order of customers and not for its own account (as contrasted with a securities dealer, which takes a position in securities). Among other things, the Court stated that "public sale" should be interpreted by reference to the activities described by the terms surrounding it in section 20—the "issue," "flotation," "underwriting," and "distribution" of securities.[6]

Reference to the other activities listed along with "public sale" in section 20, such as "underwriting," supports the Board's view that dealing activities are covered by that statute. As the Court in *Schwab* recognized, in the typical underwriting transaction the underwriter purchases securities from an issuer and resells them to the public and thus, like a dealer, normally acts as a principal in the transaction.[7] Like an underwriter, a

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4 S. Rep. No. 77, 73d Cong., 1st Sess. 10 (1933). Members of Congress criticized the association of banks with the "speculative business of dealing in securities" (75 Cong. Rec. 9904 (1932) (statement of Sen. Walcott)) and banks' establishment of departments that not only began "to engage in the origination, underwriting, and distribution" of investment securities, but also "to trade in them" (75 Cong. Rec. 9911 (1932) (statement of Sen. Bulkley)).

5 75 Cong. Rec. 9905 (1932). See also 75 Cong. Rec. 9912 (1932) (statement of Sen. Bulkley) ("Obviously, the banker who has nothing to sell his depositors is much better qualified to advise disinterestedly" than is the banker who is to receive "an underwriting profit . . . *or a trading profit*") (emphasis added).

6 468 U.S. at 218.

7 *Id.* at 217-18 & n.17.

dealer in securities "buys and sells securities on its own account thereby assuming all risk of loss."[8] Indeed, the Court in *Schwab* stated that section 20 would prohibit a bank affiliate from "dealing in" securities for its own account.[9]

The Board's view that dealing in securities is covered by the language in section 20 is further supported by the Board's long-standing and consistent interpretation that dealing is covered by the related language of section 32 of the Glass-Steagall Act (12 U.S.C. § 78). Section 32 prohibits interlocking officer, director or employee relationships between a member bank and any entity "primarily engaged" in the issue, flotation, underwriting, public sale or distribution of securities. For example, in 1934, the year that the Glass-Steagall Act became effective, the Board ruled that "it is the purpose of section 32 to restrict relationships between member banks and organizations which are directly interested in issues of securities through underwriting, distributing, or *dealing* in such issues."[10] Similarly, in 1965, the Board stated that ". . . acting as a dealer, or generally speak-

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8 *Id.* at 218 n. 18.

9 *Id.* at 219 n.20. The Board notes that the heading given section 20 in its codification in title 12 of the United States Code indicates that the statute applies to affiliation with "an organization dealing in securities." 12 U.S.C. § 377 (1934). The heading for section 20 in a compilation of national banking laws published under the direction of the Comptroller of the Currency shortly after section 20 was enacted was "Relationships between Member Banks and Securities Dealers." *The National Bank Act as Amended and Other Laws Relating to National Banks* (U.S. Government Printing Office, July 1, 1933).

10 20 FEDERAL RESERVE BULLETIN 393 (1934) (emphasis added). *Accord*, 20 FEDERAL RESERVE BULLETIN 750 (1934), where the Board interpreted section 32 to apply to the manager of a branch of a *dealer* in securities. As originally enacted, section 32 prohibited an interlock with a firm engaged "primarily in the business of purchasing, selling or negotiating securities." 48 Stat. 194. While an amendment to the statute in 1935 changed this provision to conform to the other provisions of the Act (49 Stat. 709), the amendment was not intended to change the scope of coverage of section 32. *See* H.R. Rep. No. 742, 74th Cong., 1st Sess. 17 (1935).

ing, selling or distributing securities as a principal, is covered by [the language of section 32]."[11] In its *Schwab* decision, the Supreme Court expressly stated that, because sections 32 and 20 are complementary provisions of the Glass-Steagall Act, contain identical language and were enacted for similar purposes, long-accepted Board interpretations of section 32 "should apply as well to § 20."[12]

Finally, interpreting "public sale" to include securities dealing activities is consistent with the basic purposes of the Glass-Steagall Act. Since a dealer operates for its own account in particular securities, *i.e.*, with its own funds, the dealer is subject to the "inherent risks of the securities business" and to the "more subtle hazards" that arise when a banking organization has a pecuniary interest in the purchase and sale of particular securities.[13] In *Schwab*, the Supreme Court stated that "[a]ll these 'subtle hazards' are attributable to the promotional pressures that arise from affiliation with entities that purchase and sell particular investments on their own account." 468 U.S. at 220 n.23.

The hazards and abuses presented by the business of trading in securities for one's own account are not limited to the distribution of securities but may also arise in the context of secondary market trading where the activities are conducted on a principal basis.[14] For example, a bank might be tempted to promote to its customers the sale of securities held in an affiliate's

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11 51 Federal Reserve Bulletin 810 (1965); 12 C.F.R. § 218.110. The fact that these Board interpretations were issued prior to the Supreme Court's *Schwab* decision is not persuasive. As noted above, the Supreme Court in *Schwab* stated, consistent with the Board's interpretation, that section 20 prohibits a bank affiliate from dealing in securities. 468 U.S. at 219 n.20.

12 468 U.S. at 219.

13 *Securities Industry Ass'n* v. *Board of Governors of the Federal Reserve System*, 468 U.S. 137, 145 (1984); *Schwab*, 468 U.S. at 220.

14 *See Investment Company Institute* v. *Camp*, 401 U.S. 617, 629-34 (1971).

dealer inventory, particularly when the affiliate is a market maker in particular securities. There may also be the temptation for the bank to make loans to customers in order to facilitate the purchase of securities dealt in by an affiliate or to extend credit or other aid to the affiliate when it is faring badly due to losses from dealing operations.

Moreover, the fact that section 16 of the Glass-Steagall Act (12 U.S.C. § 24 Seventh) expressly prohibits banks from engaging in general securities dealing activities suggests that this function is the kind of activity Congress viewed as giving rise to unwarranted risks and hazards when conducted by a banking organization.

APPENDIX C

The Chase Manhattan Corporation
New York, New York

Order Conditionally Approving Application to Underwrite and Deal in Certain Securities to a Limited Extent

The Chase Manhattan Corporation, New York, New York, a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y, 12 C.F.R. § 225.21(a), to engage through a wholly owned subsidiary, Chase Manhattan Securities, Inc. ("Company"),[1] in underwriting and dealing in, on a limited basis, the following securities:

(1) municipal revenue bonds, including certain industrial development bonds;

(2) residential mortgage-related securities; and

(3) consumer-receivable-related securities ("CRRs").[2]

In addition, Applicant has applied for approval under section 4(c)(8) of the BHC Act for Company to underwrite and deal in U.S. government and agency and state and municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Banking Act of 1933 (the "Glass-Steagall Act") (12 U.S.C. § 24 Seventh) (hereinafter "eligible securities"). Company would engage in the proposed under-

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1 Company is presently operating as Chase Manhattan Treasury Corporation.

2 Applicant proposes to limit Company's underwiting and dealing activity in the securities to 10 percent of the total business of the underwriting subsidiary as measured by dollar volume and assets as well as 3 percent of the market.

writing and dealing activities through offices in New York, California, Illinois, Massachusetts, Pennsylvania, and Texas.[3]

Applicant, with consolidated assets of $94.8 billion,[4] is the third largest banking organization in the nation. It operates seven subsidiary banks in New York, Maryland, Ohio, Delaware, Florida, and Arizona and engages in a broad range of permissible nonbanking activities in the United States and abroad.

Notice of the application, affording interested persons an opportunity to submit comments on the proposal, has been published (52 *Federal Register*, 1,380 (1987)). The Board received two comments on the proposal. The Securities Industry Association ("SIA"), a trade association of the investment banking industry, opposes the application for the reasons stated in its earlier protests to similar applications by Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation. The Dealer Bank Association commented in favor of the application.

The Board has previously determined that underwriting and dealing in eligible securities is closely related to banking under section 4(c)(8) of the BHC Act. 12 C.F.R. § 225.25(b)(16). In addition, the Board concludes that Company's performance of this activity may reasonably be expected to result in public benefits which would outweigh adverse effects under the proper incident to banking standard of section 4(c)(8) of the BHC Act. Accordingly, Applicant may engage through Company in underwriting and dealing in eligible securities to the extent that state member banks are authorized by section 16 of the Glass-Steagall Act.

On April 30, the Board approved applications by Citicorp, J.P. Morgan and Bankers Trust to underwrite and deal in, through their eligible securities underwriting subsidiaries, 1-4

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3 The Board has previously authorized Applicant to underwrite and deal in third party commercial paper through a commercial finance subsidiary, Chase Commercial Corporation, Englewood, New Jersey, subject to 5 percent gross revenues and market limitations. *The Chase Manhattan Corporation*, 73 FEDERAL RESERVE BULLETIN 367 (1987).

4 Banking data are as of December 31, 1986.

family mortgage-backed securities, municipal revenue bonds (and certain industrial development bonds) and (except for Citicorp) commercial paper.[5] The Board concluded that the underwriting subsidiaries would not be "engaged principally" in undewriting or dealing in securities within the meaning of section 20 of the Glass-Steagall Act[6] provided they derived no more than 5 percent of their total gross revenues from underwriting and dealing in the approved securities over any two-year period and their underwriting and dealing activities did not exceed 5 percent of the market for each particular type of securities involved. The Board further found that, subject to the prudential framework of limitations established in those cases to address the potential for conflicts of interest, unsound banking practices or other adverse effects, the proposed underwriting and dealing activities were so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act. In the case of CRRs, the Board concluded that the record then before it did not provide a sufficient evidentiary basis for it to make the formal finding required by the BHC Act, but stated that it would reconsider the matter within 60 days of its Order on the basis of fuller submissions.

For the reasons set forth in the Board's *Citicorp/Morgan/Bankers Trust* Order, the Board concludes that Applicant's proposal to engage through Company in underwriting and dealing in municipal revenue bonds[7] and 1-4 family mortgage-

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5 *Citicorp/Morgan/Bankers Trust, supra.*

6 Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) prohibits the affiliation of a member bank with "any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. . . ."

7 The industrial development bonds approved in those applications and for Applicant in this case are only those tax exempt bonds in which the government issuer, or the governmental unit on behalf of which the bonds are issued, is the owner for federal income tax purposes of the financed facility (such as airports, mass commuting facilities, and water pollution control facilities). Without further approval from the Board, Company may underwrite or deal in only these types of industrial development bonds.

related securities would not result in a violation of section 20 of the Glass-Steagall Act and is closely related and a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act provided Applicant limits Company's activities as provided in the *Citicorp/Morgan/Bankers Trust* Order. The Board will reconsider the permissibility of Applicant's proposal with respect to CRRs within 60 days. Accordingly, the Board has determined to approve the underwriting application subject to all of the terms and conditions established in the *Citicorp/Morgan/Bankers Trust* Order. The Board hereby adopts and incorporates herein by reference the reasoning and analysis contained in the *Citicorp/Morgan/Bankers Trust* Order.

The Board's approval of this application extends only to activities conducted within the limitations of section 225.25(b)(16) of the Board's Regulation Y and the *Citicorp/Morgan/Bankers Trust* Order, including the Board's reservation of authority to establish additional limitations to ensure that the subsidiary's activities are consistent with safety and soundness, conflict of interest and other relevant considerations under the BHC Act. Underwriting and dealing in the approved securities in any manner other than as approved in that Order[8] is not within the scope of the Board's approval and is not authorized for Company.

As the Board noted in the *Citicorp/Morgan/Bankers Trust* Order, Congress has under consideration legislation that would prohibit Board approval of an underwriting application, such as this, between March 6, 1987 and March 1, 1988. While this moratorium legislation has not yet been enacted into law, the Board calls to Applicant's attention that it may be required by subsequent Congressional action to cease its underwriting and dealing activities approved in this Order. The Board retains jurisdiction over the application to act to carry out the requirements of any legislation adopted by Congress that would affect

8 Company may also provide services that are necessary incidents to these approved activities. The incidental services should be taken into account in computing the gross revenue and market share limits on the underwriting subsidiaries' ineligible underwriting and dealing activities, to the extent such limits apply to particular incidental activities.

Applicant's conduct of underwriting and dealing activities under this Order and the BHC Act.

The Board's determination is subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders issued thereunder.

This transaction shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of New York, pursuant to delegated authority.

By order of the Board of Governors, effective May 18, 1987.

Voting for this action: Governors Johnson, Seger, and Heller. Voting against this action: Chairman Volcker and Governor Angell.

James McAfee
Associate Secretary of the Board

[SEAL]

Dissenting Statement of Chairman Volcker and Governor Angell

For the reasons set forth in our dissenting statement in the *Citicorp/Morgan/Bankers Trust* Order, we regret we are unable to join the majority in approving this application.

May 18, 1987

APPENDIX D

Chemical New York Corporation
New York, New York

Order Conditionally Approving Applications to Underwrite and Deal in Certain Securities to a Limited Extent and to Place Commercial Paper

Chemical New York Corporation, New York, New York, a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y, 12 C.F.R. § 225.21(a), to engage through a wholly owned subsidiary, Chemical Securities, Inc. ("Company"), in underwriting and dealing in, on a limited basis, the following securities:

(1) municipal revenue bonds, including certain industrial development bonds;

(2) residential mortgage-related securities;

(3) consumer-receivable-related securities ("CRRs"); and

(4) commercial paper.[1]

Applicant has also applied separately for Company to act as agent for issuers of commercial paper and other short-term promissory notes in connection with the placement of such notes with institutional customers.

Applicant has previously received approval under section 4(c)(8) of the BHC Act for Company to underwrite and deal in U.S. government and agency and state and municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Banking Act of 1933 (the "Glass-Steagall Act") (12 U.S.C. § 24 Seventh) (hereinafter "eligible

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1 Applicant proposes to limit Company's underwriting and dealing activity in these securities in the same manner and to the same extent as proposed by Bankers Trust in its application to underwrite and deal in these securities. See *Citicorp/J.P. Morgan & Co. Incorporated/ Bankers Trust New York Corporation*, Order dated April 30, 1987, pp. 17-18 n.11.

securities").[2] The proposed new underwriting and dealing activities would be provided in addition to the previously approved activities, with Company serving customers through offices in New York.

Applicant, with total consolidated assets of $60.6 billion, is the seventh largest commercial banking organization in the nation.[3] It operates 69 subsidiary banks in New York, Delaware, Colorado, Florida, and Texas and engages directly and through subsidiaries in a broad range of permissible nonbanking activities.

Notice of the applications, affording interested persons an opportunity to submit comments on the proposals, has been published (51 Federal Register 42,003 and 42,300 (1986)). The Board received two comments on each proposal. The Securities Industry Association ("SIA"), a trade association of the investment banking industry, opposes the applications for the reasons stated in its earlier protests to similar applications by Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation. The Dealer Bank Association commented in favor of the applications.

On April 30, the Board approved applications by Citicorp, J.P. Morgan and Bankers Trust to underwrite and deal in, through their eligible securities underwriting subsidiaries, 1-4 family mortgage-backed securities, municipal revenue bonds (and certain industrial development bonds) and (except for Citicorp) commercial paper.[4] The Board concluded that the underwriting subsidiaries would not be "engaged principally" in underwriting or dealing in securities within the meaning of section 20 of the Glass-Steagall Act[5] provided they derived no

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2 These activities are authorized for bank holding companies under section 225.25(b)(16) of Regulation Y. 12 C.F.R. § 225.25(b)(16).

3 Banking data are as of December 31, 1986.

4 *Citicorp/Morgan/Bankers Trust, supra.*

5 Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) prohibits the affiliation of a member bank with "any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. . . ."

more than 5 percent of their total gross revenues from underwriting and dealing in the approved securities over any two year period and their underwriting and dealing activities did not exceed 5 percent of the market for each particular type of security involved. The Board further found that, subject to the prudential framework of limitations established in those cases to address the potential for conflicts of interest, unsound banking practices or other adverse effects, the proposed underwriting and dealing activities were so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act. In the case of CRRs, the Board concluded that the record then before it did not provide a sufficient evidentiary basis for it to make the formal finding required by the BHC Act, but stated it would reconsider the matter within 60 days of its Order on the basis of fuller submissions.

For the reasons set forth in the Board's *Citicorp/Morgan/Bankers Trust* Order, the Board concludes that Applicant's proposal for Company to underwrite and deal in municipal revenue bonds,[6] commercial paper and 1-4 family mortgage-related securities would not result in a violation of section 20 of the Glass-Steagall Act and is closely rated and a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act, provided Applicant limits Company's activities as provided in the *Citicorp/Morgan/Bankers Trust* Order. The Board will reconsider the permissibility of Applicant's proposal with respect to CRRs within 60 days. Accordingly, the Board has determined to approve the underwriting application subject to all of the terms and conditions established in the *Citicorp/Morgan/Bankers Trust* Order. The Board hereby adopts and incorporates herein by reference the reasoning and analysis contained in the *Citicorp/Morgan/Bankers Trust* Order.

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6 The industrial development bonds approved in these applications and for Applicant in this case are only those tax exempt bonds in which the governmental issuer, or the governmental unit on behalf of which the bonds are issued, is the owner for federal income tax purposes of the financed facility (such as airports, mass commuting facilities, and water pollution control facilities). Without further approval from the Board, Company may underwrite or deal in only these types of industrial development bonds.

For the reasons set forth in the Board's *Bankers Trust* commercial paper placement decision,[7] the Board concludes that Applicant's proposal to place commercial paper is also consistent with section 20 of the Glass-Steagall Act and permissible for bank holding companies under section 4(c)(8) of the BHC Act, subject to the prudential limitations of that Order and the *Citicorp/Morgan/Bankers Trust* Order.

The Board's approval of these applications extends only to activities conducted within the limitations of the *Citicorp/Morgan/Bankers Trust* Order and the *Bankers Trust* commercial paper placement Order, including the Board's reservation of authority to establish additional limitations to ensure that the subsidiary's activities are consistent with safety and soundness, conflict of interest and other relevant considerations under the BHC Act. Underwriting and dealing in the approved securities, or acting as agent for the placement of commercial paper, in any manner other than as approved in those Orders[8] is not within the scope of the Board's approval and is not authorized for Company.

As the Board noted in the *Citicorp/Morgan/Bankers Trust* Order, Congress has under consideration legislation that would prohibit Board approval of an underwriting application, such as this, between March 6, 1987 and March 1, 1988. While this moratorium legislation has not yet been enacted into law, the Board calls to Applicant's attention that it may be required by subsequent Congressional action to cease its underwriting and

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7 *Bankers Trust New York Corporation*, 73 FEDERAL RESERVE BULLETIN 138 (1987). Company may underwrite, deal in and place only commercial paper that is exempt from the registration and prospectus requirements of the Securities Act of 1933 and that is short term, of prime quality, and issued in denominations no smaller than $100,000. Applicant has stated the paper will be issued or backed by large companies and sold to financially sophisticated corporate and other institutional investors.

8 Company may also provide services that are necessary incidents to these approved activities. The incidental services should be taken into account in computing the gross revenue and market share limits on the underwriting subsidiaries' ineligible underwriting and dealing activities, to the extent such limits apply to particular incidental activities.

dealing activities approved in this Order. The Board retains jurisdiction over the applications to act to carry out the requirements of any legislation adopted by Congress that would affect Applicant's conduct of underwriting and dealing activities under this Order and the BHC Act.

The Board's determination is subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders issued thereunder.

This transaction shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of New York, pursuant to delegated authority.

By order of the Board of Governors, effective May 18, 1987.

Voting for this action: Governors Johnson, Seger, and Heller. Voting against this action: Chairman Volcker and Governor Angell.

James McAfee
Associate Secretary of the Board

[SEAL]

Dissenting Statement of Chairman Volcker and Governor Angell

For the reasons set forth in our dissenting statement in the *Citicorp/Morgan/Bankers Trust* Order, we regret we are unable to join the majority in approving this application.

May 18, 1987

APPENDIX E

Citicorp
New York, New York

Order Approving Application to Underwrite and Deal in Commercial Paper to a Limited Extent

Citicorp, New York, New York, a bank holding company within the meaning of the Bank Holding Company Act, 12 U.S.C. § 1841 *et seq.* ("BHC Act"), has applied pursuant to section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)) and section 225.21(a) of the Board's Regulation Y (12 C.F.R. § 225.21(a)) to engage through Citicorp Securities, Inc. ("CSI"), a wholly owned subsidiary, in underwriting and dealing in commercial paper to a limited extent.[1]

Applicant has previously received Board approval for CSI to underwrite and deal in U.S. government and agency and state and municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Banking Act of 1933 (the "Glass-Steagall Act") (12 U.S.C. § 24 Seventh) (hereinafter "eligible securities").[2] On April 30, 1987, the Board authorized Citicorp to engage through CSI in underwriting and dealing in 1-4 family mortgage-backed securities and municipal revenue bonds.[3]

Citicorp, with total consolidated assets of $196 billion, is the largest banking organization in the nation.[4] It operates eight banking subsidiaries and engages directly and through subsidiaries in a broad range of permissible nonbanking activities.

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1 Applicant proposes to limit CSI's underwriting and dealing activity in commercial paper as described in its application to underwrite and deal in municipal revenue bonds, mortgage-backed securities and consumer-receivable-related securities. *See Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation* ("*Citicorp/Morgan/Bankers Trust*"), Order dated April 30, 1987, pp. 17-18 n.11.

2 These activities are authorized for bank holding companies under section 225.25(b)(16) of Regulation Y. 12 C.F.R. § 225.25(b)(16).

3 *Citicorp/Morgan/Bankers Trust, supra.*

4 All asset data are as of December 31, 1986.

Notice of the application, affording interested persons an opportunity to submit comments on the proposal, has been published (52 *Federal Register* 13,317 (1987)). The Securities Industry Association ("SIA"), a trade association of the investment banking industry, opposes the application for the reasons stated in its earlier protests to similar applications by Citicorp, J.P. Morgan and Bankers Trust.

In its *Citicorp/Morgan/Bankers Trust* decision, the Board concluded that CSI and the eligible securities underwriting subsidiaries of J.P. Morgan and Bankers Trust would not be "engaged principally" in underwriting or dealing in municipal revenue bonds, 1-4 family mortgage-backed securities and (except for Citicorp) commercial paper within the meaning of section 20 of the Glass-Steagall Act[5] provided they derived no more than 5 percent of their total gross revenues from underwriting and dealing in the approved securities over any two year period and their underwriting and dealing activities did not exceed 5 percent of the market for each particular type of security involved. The Board further found that, subject to the prudential framework of limitations established in those cases to address the potential for conflicts of interest, unsound banking practices or other adverse effects, the proposed underwriting and dealing activities were so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act.

For the reasons set forth in the *Citicorp/Morgan/Bankers Trust* Order,[6] the Board concludes that Applicant's proposal for CSI to underwrite and deal in commercial paper would not result in a violation of section 20 of the Glass-Steagall Act and

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5 Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) prohibits the affiliation of a member bank with "any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. . . ."

6 In *The Chase Manhattan Corporation*, 73 FEDERAL RESERVE BULLETIN 367 (1987), the Board found that underwriting commercial paper was closely related to banking under section 4(c)(8) of the BHC Act. The *Citicorp/Morgan/Bankers Trust* decision incorporated the findings.

is closely related and a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act provided Applicant limits CSI's activities as provided in the *Citicorp/Morgan/Bankers Trust* Order. Accordingly, the Board has determined to approve the application subject to the terms and conditions established in the *Citicorp/Morgan/Bankers Trust* Order. The Board hereby adopts and incorporates herein by reference the reasoning and analysis contained in the *Citicorp/Morgan/Bankers Trust* and *Chase* Orders.

The Board's approval of this application extends only to activities conducted within the limitations of the *Citicorp/Morgan/Bankers Trust* Order, including the Board's reservation of authority to establish additional limitations to ensure that the subsidiary's activities are consistent with safety and soundness, conflict of interest and other relevant considerations under the BHC Act. Underwriting and dealing in commercial paper in any manner other than as approved in that Order[7] is not within the scope of the Board's approval and is not authorized for CSI.

As the Board noted in the *Citicorp/Morgan/Bankers Trust* Order, Congress has under consideration legislation that would prohibit Board approval of an underwriting application, such as this, between March 6, 1987 and March 1, 1988. While this moratorium legislation has not yet been enacted into law, the Board calls to Applicant's attention that it may be required by subsequent Congressional action to cease its underwriting and dealing activities approved in this Order. The Board retains jurisdiction over the application to act to carry out the requirements of any legislation adopted by Congress that would affect Applicant's conduct of the underwriting and dealing activities under this Order and the BHC Act.

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7 CSI may also provide services that are necessary incidents to these approved activities. The incidental services should be taken into account in computing the gross revenue and market share limits on the underwriting subsidiaries' ineligible underwriting and dealing activities, to the extent such limits apply to particular incidental activities.

The Board's determination is subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders issued thereunder.

This transaction shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of New York, pursuant to delegated authority.

By order of the Board of Governors, effective May 18, 1987.

Voting for this action: Governors Johnson, Seger, and Heller. Voting against this action: Chairman Volcker and Governor Angell.

Associate Secretary of the Board
James McAfee

[SEAL]

Dissenting Statement of Chairman Volcker and Governor Angell

For the reasons set forth in our dissenting statement in the *Citicorp/Morgan/Bankers Trust* order, we regret we are unable to join the majority in approving this application.

May 18, 1987

APPENDIX F

Manufacturers Hanover Corporation
New York, New York

Order Conditionally Approving Application to Underwrite and Deal in Certain Securities to a Limited Extent and to Place Commercial Paper

Manufacturers Hanover Corporation, New York, New York, a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y, 12 C.F.R. § 225.21(a), to engage through a wholly owned subsidiary, Manufacturers Hanover Securities Corporation ("Company"), in underwriting and dealing in, on a limited basis, the following securities:

(1) municipal revenue bonds, including certain industrial development bonds;

(2) residential mortgage-related securities;

(3) consumer-receivable-related securities ("CRRs"); and

(4) commercial paper.[1]

Applicant has also applied for Company to act as agent for issuers of commercial paper in connection with the placement of such notes with institutional customers.

Applicant has previously received approval under section 4(c)(8) of the BHC Act for Company to underwrite and deal in U.S. government and agency and state and municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Banking Act of 1933 (the "Glass-Steagall Act") (12 U.S.C. § 24 Seventh) (hereinafter "eligible

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1 Applicant proposes to limit Company's underwriting and dealing activity in these securities in the same manner and to the same extent as proposed by Bankers Trust in its application to underwrite and deal in these securities. *See Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation*, Order dated April 30, 1987, pp. 17-18 n.11.

securities").[2] In addition, Company, pursuant to Board authorization, engages in securities brokerage services pursuant to section 225.25(b)(15) of Regulation Y, 12 C.F.R. § 225.25-(b)(15). These brokerage services are conducted separately from the eligible securities underwriting and dealing activity. The proposed new underwriting and dealing activities would be provided in addition to the previously approved activities, with Company serving customers through offices in New York.

Applicant, with total consolidated assets of $75.8 billion, is the fifth largest commercial banking organization in the nation.[3] It operates two subsidiary banks in New York and Delaware and engages directly and through subsidiaries in a broad range of permissible nonbanking activities.

Notice of the application, affording interested persons an opportunity to submit comments on the proposal, has been published (52 *Federal Register* 6,218 (1987)). The Board received two comments on the proposal. The Securities Industry Association ("SIA"), a trade association of the investment banking industry, opposes the application for the reasons stated in its earlier protests to similar applications by Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation. The Dealer Bank Association commented in favor of the application.

On April 30, the Board approved applications by Citicorp, J.P. Morgan and Bankers Trust to underwrite and deal in, through their eligible securities underwriting subsidiaries, 1-4 family mortgage-backed securities, municipal revenue bonds (and certain industrial development bonds) and (except for Citicorp) commercial paper.[4] The Board concluded that the underwriting subsidiaries would not be "engaged principally" in underwriting or dealing in securities within the meaning of sec-

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2 These activities are authorized for bank holding companies under section 225.25(b)(16) of Regulation Y. 12 C.F.R. § 225.25(b)(16).

3 Asset data are as of March 31, 1987. Banking data are as of December 31, 1986.

4 *Citicorp/Morgan/Bankers Trust, supra.*

tion 20 of the Glass-Steagall Act[5] provided they derived no more than 5 percent of their total gross revenues from underwriting and dealing in the approved securities over any two year period and their underwriting and dealing activities did not exceed 5 percent of the market for each particular type of security involved. The Board further found that, subject to the prudential framework of limitations established in those cases to address the potential for conflicts of interest, unsound banking practices or other adverse effects, the proposed underwriting and dealing activities were so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act. In the case of CRRs, the Board concluded that the record then before it did not provide a sufficient evidentiary basis for it to make the formal finding required by the BHC Act, but stated that it would reconsider the matter within 60 days of its Order on the basis of fuller submissions.

For the reasons set forth in the Board's *Citicorp/Morgan/Bankers Trust* Order, the Board concludes that Applicant's proposal to engage through Company in underwriting and dealing in municipal revenue bonds,[6] commercial paper and 1-4 family mortgage-related securities would not result in a violation of section 20 of the Glass-Steagall Act and is closely related and a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act provided Applicant limits Company's activities as provided in the *Citicorp/Morgan/Bankers Trust* Order. The Board will reconsider the permissibility of Appli-

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5 Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) prohibits the affiliation of a member bank with "any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. . . ."

6 The industrial development bonds approved in those applications and for Applicant in this case are only those tax exempt bonds in which the governmental issuer, or the governmental unit on behalf of which the bonds are issued, is the owner for federal income tax purposes of the financed facility (such as airports, mass commuting facilities, and water pollution control facilities). Without further approval from the Board, Company may underwrite or deal in only these types of industrial development bonds.

cant's proposal with respect to CRRs within 60 days. Accordingly, the Board has determined to approve the underwriting application subject to the terms and conditions established in the *Citicorp/Morgan/Bankers Trust* Order. The Board hereby adopts and incorporates herein by reference the reasoning and analysis contained in the *Citicorp/Morgan/Bankers Trust* Order.

For the reasons set forth in the Board's Order in *Bankers Trust* approving commercial paper placement activity, the Board concludes that Applicant's proposal to place commercial paper is also consistent with section 20 of the Glass-Steagall Act and permissible for bank holding companies under section 4(c)(8) of the BHC Act, subject to the prudential limitations of that Order and the *Citicorp/Morgan/Bankers Trust* Order.[7]

The Board's approval of this application extends only to activities conducted within the limitations of the *Citicorp/Morgan/Bankers Trust* Order and the *Bankers Trust* commercial paper placement Order, including the Board's reservation of authority to establish additional limitations to ensure that the subsidiary's activities are consistent with safety and soundness, conflict of interest and other relevant considerations under the BHC Act. Underwriting and dealing in the approved securities in any manner other than as approved in those Orders[8] is not within the scope of the Board's approval and is not authorized for Company.

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7 *Bankers Trust New York Corporation*, 73 FEDERAL RESERVE BULLETIN 138 (1987). Company may underwrite, deal in and place only commercial paper that is exempt from the registration and prospectus requirements of the Securities Act of 1933 and that is short term, of prime quality, and issued in denominations no smaller than $100,000. Applicant has stated the paper will be issued or backed by large companies and sold to financially sophisticated corporate and other institutional investors.

8 Company may also provide services that are necessary incidents to these approved activities. The incidental services should be taken into account in computing the gross revenue and market share limits on the underwriting subsidiaries' ineligible underwriting and dealing activities, to the extent such limits apply to particular incidental activities.

As the Board noted in the *Citicorp/Morgan/Bankers Trust* Order, Congress has under consideration legislation that would prohibit Board approval of an underwriting application, such as this, between March 6, 1987 and March 1, 1988. While this moratorium legislation has not yet been enacted into law, the Board calls to Applicant's attention that it may be required by subsequent Congressional action to cease its underwriting and dealing activities approved in this Order. The Board retains jurisdiction over the application to act to carry out the requirements of any legislation adopted by Congress that would affect Applicant's conduct of underwriting and dealing activities under this Order and the BHC Act.

The Board's determination is subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders issued thereunder.

This transaction shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of New York, pursuant to delegated authority.

By order of the Board of Governors, effective May 18, 1987.

Voting for this action: Governors Johnson, Seger, and Heller. Voting against this action: Chairman Volcker and Governor Angell.

James McAfee
Associate Secretary of the Board

[SEAL]

Dissenting Statement of Chairman Volcker and Governor Angell

For the reasons set forth in our dissenting statement in the *Citicorp/Morgan/Bankers Trust* Order, we regret we are unable to join the majority in approving this application.

May 18, 1987

APPENDIX G

Security Pacific Corporation
Los Angeles, California

Order Conditionally Approving Application to Underwrite and Deal in Certain Securities to a Limited Extent

Security Pacific Corporation, Los Angeles, California, a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y, 12 C.F.R. § 225.21(a), to engage through a wholly owned subsidiary, Security Pacific Securities, Inc. ("Company"), in underwriting and dealing in, on a limited basis, the following securities:

(1) municipal revenue bonds, including certain industrial development bonds;

(2) residential mortgage-related securities;

(3) consumer-receivable-related securities ("CRRs"); and

(4) commercial paper.[1]

Applicant has previously received approval under section 4(c)(8) of the BHC Act for Company to underwrite and deal in U.S. government and agency and state and municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Banking Act of 1933 (the "Glass-Steagall Act") (12 U.S.C. § 24 Seventh) (hereinafter "eligible securities").[2] The proposed new underwriting and dealing activities would be provided in addition to the previously ap-

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1 Applicant proposes to limit Company's underwriting and dealing activity in these securities in the same manner and to the same extent as proposed by Bankers Trust in its application to underwrite and deal in these securities. *See Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation*, Order dated April 30, 1987, pp. 17-18 n.11.

2 These activities are authorized for bank holding companies under section 225.25(b)(16) of Regulation Y. 12 C.F.R. § 225.25(b)(16).

proved eligible securities activities, with Company serving customers through offices in Los Angeles.

Applicant, with total consolidated assets of $64.0 billion, is the sixth largest commercial banking organization in the nation.[3] It operates five subsidiary banks in California, Arizona, Washington and Oregon and engages directly and through subsidiaries in a broad range of permissible nonbanking activities.

Notice of the application, affording interested persons an opportunity to submit comments on the proposal, has been published (52 *Federal Register* 8,365 (1987)). The Board received two comments on the proposal. The Securities Industry Association ("SIA"), a trade association of the investment banking industry, opposes the application for the reasons stated in its earlier protests to similar applications by Citicorp, *J.P. Morgan & Co. Incorporated* and *Bankers Trust New York Corporation*. The Dealer Bank Association commented in favor of the application.

On April 30, the Board approved applications by Citicorp, J.P. Morgan and Bankers Trust to underwrite and deal in, through their eligible securities underwriting subsidiaries, 1-4 family mortgage-backed securities, municipal revenue bonds (including certain industrial development bonds) and (except for Citicorp) commercial paper.[4] The Board concluded that the underwriting subsidiaries would not be "engaged principally" in underwriting or dealing in securities within the meaning of section 20 of the Glass-Steagall Act[5] provided they derived no more than 5 percent of their total gross revenues from underwriting and dealing in the approved securities over any two year period and their underwriting and dealing activities did not exceed 5 percent of the market for each particular type of security

3 Asset data are as of March 31, 1987. Banking data are as of December 31, 1986.

4 *Citicorp/Morgan/Bankers Trust, supra.*

5 Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) prohibits the affiliation of a member bank with "any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. . . ."

involved. The Board further found that, subject to the prudential framework of limitations established in those cases to address the potential for conflicts of interest, unsound banking practices or other adverse effects, the proposed underwriting and dealing activities were so closely related to banking as to be a proper incident thereto within the meaning of section 4(c) of the BHC Act. In the case of CRRs, the Board concluded that the record then before it did not provide a sufficient evidentiary basis for it to make the formal findings required by the BHC Act, but stated that it would reconsider the matter within 60 days of its Order on the basis of fuller submissions.

For the reasons set forth in the Board's *Citicorp/Morgan/ Bankers Trust* Order, the Board concludes that Applicant's proposal to engage through Company in underwriting and dealing in municipal revenue bonds,[6] commercial paper and 1-4 family mortgage-related securities would not result in a violation of section 20 of the Glass-Steagall Act and is closely related and a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act provided Applicant limits Company's activities as provided in the *Citicorp/Morgan/Bankers Trust* Order. The Board will reconsider the permissibility of Applicant's proposal with respect to CRRs within 60 days. Accordingly, the Board has determined to approve the underwriting application subject to the terms and conditions established in the *Citicorp/Morgan/Bankers Trust* Order. The Board hereby adopts and incorporates herein by reference the reasoning and analysis contained in the *Citicorp/Morgan/Bankers Trust* Order.

The Board's approval of this application extends only to activities conducted within the limitations of the *Citicorp/ Morgan/Bankers Trust* Order, including the Board's reserva-

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6 The industrial development bonds approved in those applications and for Applicant in this case are only those tax exempt bonds in which the governmental issuer, or the governmental unit on behalf of which the bonds are issued, is the owner for federal income tax purposes of the financed facility (such as airports, mass commuting facilities, and water pollution control facilities). Without further approval from the Board, Company may underwrite or deal in only these types of industrial development bonds.

tion of authority to establish additional limitations to ensure that the subsidiary's activities are conducted consistent with safety and soundness, conflict of interest and other relevant considerations under the BHC Act. Underwriting and dealing in the approved securities in any manner other than as approved in that Order[7] is not within the scope of the Board's approval and is not authorized for Company.

As the Board noted in the *Citicorp/Morgan/Bankers Trust* Order, Congress has under consideration legislation that would prohibit Board approval of an underwriting application, such as this, between March 6, 1987 and March 1, 1988. While this moratorium legislation has not yet been enacted into law, the Board calls to Applicant's attention that it may be required by subsequent Congressional action to cease its underwriting and dealing activities approved in this Order. The Board retains jurisdiction over the application to act to carry out the requirements of any legislation adopted by Congress that would affect Applicant's conduct of underwriting and dealing activities under this Order and the BHC Act.

The Board's determination is subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders issued thereunder.

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7 Company may also provide services that are necessary incidents to these approved activities. The incidental services should be taken into account in computing the gross revenue and market share limits on the underwriting subsidiaries' ineligible underwriting and dealing activities, to the extent such limits apply to particular incidental activities.

Applicant has proposed to place third party commercial paper as agent as an incident to its commercial paper underwriting and dealing activity. In this case, the Board concludes that Company may, as an incident to its commercial paper underwriting and dealing activities, engage in commercial paper placement provided Company observes the prudential limitations set forth by the Board in the *Citicorp/Morgan/Bankers Trust* Order and *Bankers Trust New York Corporation*, 73 FEDERAL RESERVE BULLETIN 138 (1987).

This transaction shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of San Francisco, pursuant to delegated authority.

By order of the Board of Governors, effective May 18, 1987.

Voting for this action: Governors Johnson, Seger, and Heller. Voting against this action: Chairman Volcker and Governor Angell.

James McAfee
Associate Secretary of the Board

[SEAL]

Dissenting Statement of Chairman Volcker and Governor Angell

For the reasons set forth in our dissenting statement in the *Citicorp/Morgan/Bankers Trust* Order, we regret we are unable to join the majority in approving this application.

May 18, 1987

APPENDIX H

RELEVANT PROVISIONS OF THE BANKING ACT OF 1933 (THE GLASS-STEAGALL ACT)

SECTION 16:

12 U.S.C. § 24. Corporate Powers of Associations

Upon duly making and filing articles of association and an organization certificate a national banking association shall become, as from the date of the execution of its organization certificate, a body corporate, and as such, and in the name designated in the organization certificate, it shall have power—

* * * *

Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this chapter. The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund, except that this limitation shall not require any association to dispose of any securities lawfully held by it on August 23, 1935. As used in this section the term "investment securities" shall mean marketable obligations, evidencing indebtedness of any person, co-partnership, association, or corporation in the form of bonds, notes and/or deben-

tures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof. . . .

SECTION 20:

12 U.S.C. § 377. Affiliation with organization dealing in securities; penalties

After one year from June 16, 1933, no member bank shall be affiliated in any manner described in subsection (b) of section 221a of this title with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities: *Provided*, That nothing in this paragraph shall apply to any such organization which shall have been placed in formal liquidation and which shall transact no business except such as may be incidental to the liquidation of its affairs.

SECTION 21:

12 U.S.C. § 378. Dealers in securities engaging in banking business; individuals or associations engaging in banking business; examinations and reports; penalties

(a) After the expiration of one year after June 16, 1933, it shall be unlawful—

(1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or

retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor: *Provided*, That the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of section 24 of this title: *Provided further*, That nothing in this paragraph shall be construed as affecting in any way such right as any bank, banking association, savings bank, trust company, or other banking institution, may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate;

* * * *

SECTION 32:

12 U.S.C. § 78. Certain persons excluded from serving as officers, directors or employees of member banks

No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.

87-1513

No. 88-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

SECURITIES INDUSTRY ASSOCIATION,
Petitioner,

v.

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM, ET AL.,
Respondents.

BRIEF *AMICUS CURIAE* IN SUPPORT OF THE PETITION OF THE SECURITIES INDUSTRY ASSOCIATION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED

1. When Section 20 of the Glass-Steagall Act, 12 U.S.C. § 377, expressly prohibits affiliates of member banks of the Federal Reserve System from "engag[ing] principally" in underwriting and dealing in *all* "securities" without exception, and when this Court repeatedly has held that the Act's prohibitory terms must be applied "as they were written," did the court below err in upholding a split decision of the Federal Reserve Board disregarding the plain statutory language and excepting government securities from the scope of Section 20's flat prohibitions?

2. When Section 20 prohibits bank affiliates from "engag[ing] principally" in underwriting and dealing in non-government securities, did the court below err in permitting bank affiliates to do so regularly as an integral part of their business?

PARTIES TO THE PROCEEDING

In addition to the petitioner[1] and respondent listed in the caption, the following are also respondents in this action: Alan Greenspan, as Chairman of the Board of Governors of the Federal Reserve System; Manuel H. Johnson, Martha R. Seger, Wayne D. Angell and H. Robert Heller as Members of the Board of Governors of the Federal Reserve System; and Bankers Trust New York Corporation, J.P. Morgan & Co., Citicorp, The Chase Manhattan Corporation, Manufacturers Hanover Corporation, Chemical New York Corporation and Security Pacific Corporation, as Intervenors-Respondents-Cross-Petitioners.[2]

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1. Pursuant to Rule 28.1 of this Court, *amicus curiae* Investment Company Institute states that it is the national association of open-end investment companies (commonly known as mutual funds), their investment advisers and their principal underwriters. The Institute has 2,417 mutual fund members with over 29 million shareholders and assets of approximately $865 billion.

2. Paul A. Volcker, Chairman Greenspan's predecessor as Chairman of the Board of Governors of the Federal Reserve System, was named as a respondent below.

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No. 88-

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v.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, ET AL.,

Respondents.

BRIEF *AMICUS CURIAE* IN SUPPORT OF THE PETITION OF THE SECURITIES INDUSTRY ASSOCIATION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Amicus Curiae Investment Company Institute (the "Institute") respectfully submits this brief in support of the Petition of the Securities Industry Association (the "SIA") requesting that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in these proceedings on February 8, 1988.

INTEREST OF THE INSTITUTE

The Institute is the national association of open-end investment companies (commonly known as mutual funds), their investment advisers and their principal underwriters. The Institute is generally recognized as the primary spokesman for the mutual fund industry and, as such, has been intimately involved in numerous judicial and administrative proceedings with respect to the scope and application of the Glass-Steagall Act, both as a party, *see, e.g., **Board of Governors** v. **Investment Company Institute**,* 450 U.S. 46 (1981) *(**"Board of Governors"**); **Investment Company Institute** v. **Camp**,* 401 U.S. 617 (1971) *(**"Camp"**)*, and as *amicus curiae*. *See, e.g., **Securities Industry Association** v. **Board of***

Governors, 468 U.S. 137 (1984) (*"Becker"*). The Institute participated in this case before the Board of Governors of the Federal Reserve System (the "Board") and submitted a brief *amicus curiae* in the court below.

The Institute has a substantial interest in this case because its members are adversely affected by the administrative exercise of legislative power affirmed by the Court of Appeals. Notwithstanding the Congressional intent embodied in the Glass-Steagall Act to "abolish the security affiliates of commercial banks," *Camp*, 401 U.S. at 629, and Congress' repeated reaffirmation of this fundamental national policy, the Second Circuit affirmed a decision of a majority of the Board, entered over the strong dissent of Chairman Volcker and Governor Angell, which sanctioned their recreation.

The members of the Institute are further directly aggrieved by the unprecedented interpretation of the Glass-Steagall Act endorsed below. Although most members of the Institute do not underwrite the specific securities at issue in the precise applications here involved, they are concerned that the language and rationale of the majority opinion will be extended to authorize incursions into other areas of the securities business, including the mutual fund business, forbidden to bank affiliates by Congress over fifty years ago. There already are indications that this concern is well-founded.[1]

STATEMENT OF THE CASE

The Institute adopts the statement of the case set forth in the Petition of the SIA.

REASONS FOR GRANTING THE WRIT

As the SIA has demonstrated in its Petition, the judgment below raises profound questions of national importance. The

1. *See, e.g., Chase Account Links Returns to Stock Prices*, Wall St. J., March 19, 1987, at 26, col. 2 (noting the upcoming filing of an application by The Chase Manhattan Corporation with the Board to create bank affiliates engaged in the mutual fund business under the rationale of the Board majority opinion under review).

SIA also has shown that the Second Circuit's decision contravenes the decisions of this Court as well as the language, structure and purpose of Section 20 of the Glass-Steagall Act. The Institute concurs fully in these arguments.

Action by this Court is also necessary because the opinion below fundamentally misconceives the role of administrative agencies and courts in effectuating the basic policy decisions Congress has mandated in the financial services arena. The Board has made no secret of *its* belief that bank affiliates should be permitted to engage in the securities activities at issue here. The Glass-Steagall Act, however, reflects *Congress'* considered legislative judgment that whatever "policies of competition, convenience, or expertise" might be furthered by commercial bank securities affiliates are outweighed by the dangers and hazards that arise when banks seek to combine the business of banking with the business of underwriting and dealing in securities. *Camp*, 401 U.S. at 630.

The duty of the Second Circuit was to give effect to this legislative judgment and not, by affirming the Board majority opinion, to subvert it. As this Court has instructed, if existing banking statutes do not serve the public interest, "that is a problem for Congress, and not the Board or the cou ts, to address." *Board of Governors* v. *Dimension Financial Corp.*, 474 U.S. 361, 374 (1986).

The Second Circuit endorsed the recreation of bank securities affiliates by approving the Board majority's exception of government securities from the scope of Section 20's "securities" underwriting bar. The plain language of Section 20, however, prohibits bank affiliates from engaging principally in the underwriting of *all* "stocks, bonds, debentures, notes or other securities," and contains no exceptions at all. *See* 12 U.S.C. § 377. The advertence of that omission is demonstrated by Section 21 of the Glass-Steagall Act, which *does* expressly exempt government securities, and which shows that Congress knows how to draft and include an exception for government securities where it wants one to apply. *See* 12 U.S.C. § 378.

Moreover, as the Institute demonstrated before the Board and the Second Circuit, Section 19(e) of the Glass-Steagall Act confirms that Congress intended Section 20 to apply to all securities without exception. Section 19(e), which governed the activities of bank holding companies between 1933 and 1966, was intended to prohibit bank holding companies from being affiliated with any entity formed for the purpose or engaged principally in the underwriting of "stocks, bonds, debentures, notes or other securities *of any sort*."[2] As this Court has recognized, the standard of Section 19(e) *"is the same standard as is contained in § 20." Board of Governors*, 450 U.S. at 69, n.43 (emphasis supplied). And, as the Board itself has conceded, when Congress repealed Section 19(e) in 1966 and amended Section 20 to bring bank holding companies within its scope, Congress intended no substantive change in the law but "in effect merely substituted § 20 for § 19(e)."[3]

Unable to reconcile its administrative government securities exception with Section 19(e), the Board majority simply ignored Section 19(e) in its decision. The Second Circuit sought to fill the gap by arguing that Section 19(e) was unhelpful, since its "securities of any sort" language somehow made the unqualified term "securities" in Section 20 "ambiguous."

This argument ignores the statutory structure. As set forth above, both this Court and the Board have recognized that Sections 19(e) and 20 are of identical reach. The "securities of any sort" prohibition in Section 19(e) thus creates no ambiguity in Section 20, but confirms that Section 20 applies, "as it was written," *Camp*, 401 U.S. at 639, to *all* "securities" without exception.

Corrective action by this Court is all the more urgent in light of the adamance with which Congress has adhered to its original

2. 48 Stat. 162, 188 (emphasis supplied), codified at 12 U.S.C. § 61, *repealed*, Pub. L. No. 89-485, § 13(e), 80 Stat. 236, 242 (1966).

3. Petition of Respondent Board of Governors of the Federal Reserve System for Rehearing and Suggestion for Rehearing En Banc at 8, *Investment Company Institute v. Board of Governors*, 606 F.2d 1004 (D.C. Cir. 1979), *rev'd*, 450 U.S. 46 (1981).

policy decision to abolish bank security affiliates. Over the past 25 years, the banking industry repeatedly has requested Congress to lift or modify the Act's flat prohibitions.[4] In fact, the banking industry repeatedly has sought the authority to underwrite and deal in the exact securities that are at issue in the instant applications.[5] Notwithstanding these entreaties, however, Congress deliberately has refused to give even the slightest additional power to affiliates of member banks.[6]

Thus, the point here is not merely that the Chairmen of both the House and Senate Banking Committees have issued public statements decrying the applications approved by the Board majority's ruling,[7] or that Congress passed legislation designed to impose a moratorium by force upon these and similar Board approvals until March 1, 1988. The point, as the Board itself declared earlier in this proceeding, is that "Congress is the [only] appropriate forum for resolution of the public policy considerations involved" in such "novel proposals" that would "dramatically alter the framework established by Congress in the Glass-

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4. *See, e.g.*, H.R. Rep. No. 1631, 91st Cong., 2d Sess. 28-29 (1970) (defeat of bills authorizing banks to underwrite shares in bank mutual funds). *Compare, e.g.*, S. 1720, 97th Cong., 1st Sess. (1981) (proposing authority for banks to underwrite revenue bonds and mutual funds) *with* Pub. L. No. 97-320, 96 Stat. 1469 (1982) (containing no such authority). *See also* S. 2592, 99th Cong., 2d Sess. (1986) (proposing to allow bank holding companies to establish depository institution securities affiliates—proposal dropped from amended bill); S. 1609, 98th Cong., 1st Sess. (1983); S. 2181, 98th Cong., 1st Sess. (1983) (proposing to allow banks to underwrite and distribute mortgage-related securities and shares of investment companies).

5. *See Hearings on S. 1933 and S. 2474 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs*, 93d Cong., 2d Sess. 6, 136 (1974) (noting that legislation authorizing banks to underwrite and deal in revenue bonds had been introduced and defeated in 1935, 1938, 1945, 1955, 1957, 1962, 1963, 1965, 1967, 1973, and 1975).

6. Indeed, as recently as 1984 the House refused to approve legislation to authorize bank affiliates to underwrite the three specific securities the majority's ruling now has purported to authorize administratively. S. 2851, 98th Cong., 2d Sess. (1984).

7. *See* Letter from William Proxmire, Chairman of the Senate Banking Committee, to Paul Volcker, Chairman of the Federal Reserve Board (Jan. 30, 1987), *reprinted in* 133 Cong. Rec. S4022-23 (Mar. 27, 1987); *The Bond Buyer*, May 4, 1987, at 3.

Steagall Act for the conduct of the commercial banking and the investment banking businesses." *Citicorp*, 71 Fed. Res. Bull. 225, 225 (1985). "The realignment of our nation's financial industries is for the elected representatives of our nation to bring to fruition by comprehensive legislation, and not for fiat by * * * administrative policymaking." *A.G. Becker, Inc.* v. *Board of Governors*, 519 F. Supp. 602, 616 (D.D.C. 1981) (footnote omitted), *rev'd*, 693 F.2d 136 (D.C. Cir. 1982), *rev'd*, 468 U.S. 137 (1984).[8]

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8. Congress continues to consider whether, and to what extent, the existing barriers separating commercial from investment banking should be dismantled. For example, the Senate Banking Committee recently reported legislation which, if enacted, would grant commercial banks the precise powers the Board majority has attempted by administrative fiat to bestow upon them. Other Senators, the Chairman of the House Banking Committee, the Chairman of the House Committee on Energy and Commerce, and members of the House, however, have expressed strong concern over the bill and its wholesale abandonment of the national banking policy embodied in the Glass-Steagall Act. *See* "Election Politics Formed Senate Bill's Shape," *American Banker*, March 7, 1988, at 3; "Aide: Dingell Stands Firm Against Underwriting," *American Banker*, March 8, 1988, at 9; "Dingell Opposes Bill Defining Insider Trading," *Wall Street Journal*, March 9, 1988, at 2. Under our form of government, it is only the Congress, and not the administrative Boardroom, which constitutes the proper forum for resolution of these issues.

CONCLUSION

For these reasons, and those set forth in the Petition of the SIA, the requested Writ of Certiorari should issue.

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Dated: March 14, 1988

(4)

No. 87-1513

In the Supreme Court of the United States

OCTOBER TERM, 1987

SECURITIES INDUSTRY ASSOCIATION, PETITIONER

v.

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM, ET AL.

*ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT*

BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether Section 20 of the Glass-Steagall Act, 12 U.S.C. 377, bars bank affiliates from dealing in or underwriting certain types of securities that banks themselves are permitted to deal in or underwrite by Sections 16 and 21 of the Act, 12 U.S.C. (& Supp. IV) 24, 378.

2. Whether the Board of Governors of the Federal Reserve System reasonably determined that Section 20 of the Glass-Steagall Act, which prevents banks from affiliating with firms that are "engaged principally" in certain securities activities, permits banks to affiliate with firms that obtain five to ten per cent of their gross revenues from those securities activities.

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TO THE UNITED STATES COURT OF APPEALS
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BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-52a) is reported at 839 F.2d 47. The orders of the Board of Governors of the Federal Reserve System (Pet. App. 53a-170a) are reported at 73 Fed. Res. Bull. 473, 607, 616, 618, 620, 622.

JURISDICTION

The judgment of the court of appeals was entered on February 8, 1988. The petition for a writ of certiorari was filed on March 12, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The Banking Act of 1933, ch. 89, 48 Stat. 162, contains four provisions, usually referred to collectively as the Glass-Steagall Act (Act), that restrict the participation

of banks and bank affiliates in specified securities activities. See *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 207, 216 (1984) (*Schwab*). Section 20 of the Act, the meaning of which is directly at issue in this case, addresses restrictions on bank affiliates; it provides that "no member bank [of the Federal Reserve System] shall be affiliated * * * with any corporation, * * * *engaged principally* in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities" (12 U.S.C. 377 (emphasis added)).

The other provisions of the Act set out limitations in similar terms. Section 16, which imposes restrictions directly on banks, generally prohibits any national bank from underwriting or dealing in securities for its own account, although a proviso to the Section exempts from this prohibition the dealing in or underwriting of specified government securities (so-called "bank-eligible securities"). 12 U.S.C. (& Supp. IV) 24 Seventh.[1] Section 21(a)(1) of the Act forbids investment banking organizations—those organizations "engaged in the business of issuing, underwriting, selling, or distributing" securities—from engaging in the business of banking; as in Section 16, however, a proviso to Section 21 makes it clear that banks may deal in bank-eligible securities. 12 U.S.C. 378(a)(1). Finally, Section 32 of the Act provides that officers, directors, and employees of firms that are "primarily engaged" in securities activities may not at the same time serve as officers, directors, or employees of member banks, unless

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[1] The securities exempted from restriction include "obligations of the United States, or general obligations of any State or of any political subdivision thereof," as well as certain types of revenue bonds and mortgage-related securities. The restrictions in Section 16 also apply to state-chartered member banks of the Federal Reserve System. 12 U.S.C. 335.

the Board has approved such overlapping service "by general regulation[ ]" (12 U.S.C. 78).

2. Beginning in 1985, each of the intervenor respondents (the Applicants) applied to the Board under the Bank Holding Company Act of 1956 (the BHCA), 12 U.S.C. 1841 *et seq.*, for permission to engage to a limited extent in underwriting and dealing in certain types of *bank-ineligible* securities—commercial paper, certain revenue bonds, mortgage-related securities, and certain consumer-receivable related securities.[2] The Applicants proposed to conduct this activity through nonbank subsidiaries that were largely engaged in underwriting and dealing in *bank-eligible* securities. See Pet. App. 7a.

On April 30, 1987, the Board conditionally approved three of those applications (Pet. App. 53a-145a),[3] concluding that the proposed activities of the underwriting subsidiaries would not run afoul of Section 20. First, the Board found that bank-eligible securities activities are not implicated by Section 20's prohibition on the affiliation of

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[2] The BHCA sets out the federal framework for the supervision and regulation of bank holding companies (companies that have control over one or more banks). The BHCA generally prohibits bank holding companies from engaging, directly or through a subsidiary, in nonbanking activities (12 U.S.C. 1843(a)), but it exempts from that prohibition activities "which the Board * * * has determined (by order or regulations) to be so closely related to banking * * * as to be a proper incident thereto" (12 U.S.C. 1843(c)(8)). Among the factors that the Board must consider in making that determination are whether the activity "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices" (12 U.S.C. 1843(c)(8)).

[3] These involved Applicants Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp. On May 18, 1987, the Board approved similar applications by the other Applicants (Pet. App. 146a-170a).

banks with firms that are engaged principally in the underwriting of "stocks, bonds, debentures, notes, or other securities" (Pet. App. 67a-74a). While noting that, on its face, Section 20 does not distinguish bank-eligible from bank-ineligible securities, the Board reasoned that Congress did not intend Section 20 to foreclose affiliates from engaging in those securities activities that are expressly permitted to member banks by Section 16 (Pet. App. 67a-69a). Citing *Board of Governors* v. *Investment Company Institute* (*ICI II*), 450 U.S. 46, 61 n.26, 64 (1981), the Board also noted that the Act imposes a "less rigorous standard" on member bank affiliates under Section 20 than upon member banks under Section 16, and that " 'a bank affiliate may engage in activities that would be impermissible for the bank itself' " (Pet. App. 68a). The Board therefore concluded that Congress necessarily intended to permit affiliates to engage in such bank-eligible activities without restriction (*ibid.*).

Having established these premises, the Board reasoned that Section 20's prohibition of bank affiliation with entities "engaged principally" in securities activities must be read to bar only affiliations with firms that are engaged principally in *bank-ineligible* securities operations (Pet. App. 74a). Looking to its prior construction of the Act, the Board concluded "that the term 'engaged principally' in section 20 denotes any substantial activity of the affiliate" (*id.* at 76a). In particular, the Board determined that "a member bank affiliate would not be principally engaged substantially in underwriting or dealing activity covered by section 20 if its gross revenue from that activity does not exceed a range of between 5 and 10 per cent of its total gross revenues" (Pet. App. 83a). And looking to the particular applications here, the Board concluded that "the lower 5 percent end of the permissible range of activity under section 20 is the appropriate quantitative level"

for applying its test. The Board recognized that this level "represents a conservative approach to measuring the level of ineligible underwriting," and explained that it "will review this determination, within one year, after Applicants have gained some experience in operating the proposed underwriting subsidiaries" (*id.* at 84a-85a).[4]

3. Petitioner, a trade association representing securities brokers, dealers, and underwriters, petitioned for review of the Board's orders, arguing that the approved activities would violate Section 20 of the Act. After undertaking a comprehensive analysis of the language and legislative history of the Act, the court affirmed the Board's orders in all respects relevant to this petition (Pet. App. 1a-52a).[5]

The court first held that the word "securities" in Section 20 refers only to bank-ineligible securities. The court began its analysis by noting that the word "securities" is

[4] The Board also made a number of other determinations that are not at issue here. In addition to ruling that bank-ineligible securities activities may not account for more than five to ten per cent of a bank affiliate's gross revenues, the Board concluded that no affiliate's operations may account for more than five to ten per cent of the market for the type of security being placed or underwritten (Pet. App. 80a, 82a). This restriction was not approved by the court of appeals (see note 5, *infra*). The Board also found that underwriting and dealing in bank-ineligible securities is "closely related" to banking within the meaning of Section 4(c)(8) of the BHCA, 12 U.S.C. 1843(c)(8) (Pet. App. 87a-95a), and that the expected public benefits from the authorized activities would outweigh the possible adverse effects (*id.* at 95a-127a).

[5] The court did invalidate the Board's restriction on market share (see note 4, *supra*), holding that "Congress indicated that its principal anxiety was over the perceived risk to bank solvency resulting from their over-involvement in securities activities. A market share limitation simply does not further reduce this congressional worry." The court added that the Board had failed to show "on the record before us that a market share limitation is an objective proxy for a sales volume test" (Pet. App. 50a).

ambiguous, since it is neither defined nor used consistently in the Act (Pet. App. 13a-14a). The court therefore looked to the Act's history and structure to "conclude that construing § 20 as not encompassing activities by bank affiliates in bank-eligible securities is essential if Congress' purpose in enacting § 20 is to be effectuated" (*id.* at 17a). The court explained that the Act was drafted as a compromise between those who advocated a complete separation of the commercial and investment banking industries on the one hand, and, on the other, those who sought to preserve some elements of the existing system of bank affiliates that engaged in securities operations (see *id.* at 26a-31a). Both sides in this debate, the court continued, viewed "Glass-Steagall [as] a means to sever commercial banking only from more speculative, 'perilous' investment activities, in which bank-eligible activities were not included" (*id.* at 30a-31a). The court therefore held that "an interpretation of 'securities' in § 20 that excludes bank-eligible securities from its reach is entirely consistent with Congress' aim" (*id.* at 31a).

The court found support for its conclusion in this Court's decisions construing the Act, which have looked to whether particular bank activities give rise to certain "subtle hazards" associated with dealing in securities. See Pet. App. 34a, citing *Schwab*, 468 U.S. at 220-221; *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 137, 154-160 (1984) (*Bankers Trust I*). The court found no such hazards in this case. It noted that Congress, in Section 16, allowed banks to underwrite and deal in bank-eligible securities, "making it plain therefore that [Congress] believed the risks were not so great when banks dealt in these securities" (Pet. App. 35a). And "[s]ince banks are allowed under § 16 to underwrite and deal in government obligations without limitation, it would be incongruous for § 20 to prohibit banks from affiliating with entities

that are merely 'engaged principally' in those same activities" (*ibid.*).

The court of appeals proceeded to uphold the Board's determination that a bank affiliate is "engaged principally" in underwriting bank-ineligible securities within the meaning of Section 20 when those activities constitute a "substantial" portion of its business. The court noted that "[t]he term 'engaged principally' is intrinsically ambiguous" (Pet. App. 39a), and it accordingly chose to defer to the Board's interpretation of the statute (see *id.* at 39a, 41a, 45a). In addition, the court found reasonable the Board's conclusion that an affiliate is substantially engaged in prohibited securities activities when those activities amount to more than five to ten per cent of the affiliate's gross revenues over a two-year period (*id.* at 46a-48a); "[b]ecause of the Board's expertise [the court] also defer[red] to its decision to set the gross revenue limitation at five percent" (*id.* at 48a).

ARGUMENT

As petitioner itself acknowledges (Pet. 10), the question in this case is one of first impression. That question arises in an area that has received considerable attention from Congress in recent years; indeed, legislation that would largely moot this case has passed the Senate and is now pending in the House. And after giving extensive consideration to petitioner's contentions, the Board and the court of appeals gave the question here the only answer that accords with the structure and purposes of existing law. For all of these reasons, further review is not warranted.

1. a. Although petitioner makes a series of empirical assertions (see Pet. 13-15), its central legal contention is the argument (Pet. 17-23) that the word "securities" in Sec-

tion 20 refers to bank-eligible, as well as to bank-ineligible, securities. Petitioner therefore argues that Section 20 bars the affiliation of member banks with firms that are "engaged principally" in activities involving bank-eligible securities. This argument is insupportable.

It is a truism that the Act was adopted because Congress believed that risky securities activities posed a threat to the solvency of banks and thus to bank depositors. See, *e.g.*, *ICI II*, 450 U.S. at 61. In Sections 16 and 21 of the Act, however, Congress expressly provided that banks themselves may deal in bank-eligible securities because, as the court of appeals explained, "underwriting and dealing in [such] securities pose no hazards to banks" (Pet. App. 36a); "the fact that § 16 * * * allows banks to engage directly in * * * [a given activity] suggests that the activity was not the sort that concerned Congress in its effort to secure the Nation's banks from the risks of the securities market" (*Schwab*, 468 U.S. at 221). At the same time, Section 20 – by permitting bank affiliation with firms that are not "engaged principally" in securities operations – imposes a "less stringent standard" on affiliates than on banks (*ICI II*, 450 U.S. at 61 n.26), permitting a bank affiliate to engage in securities "activities that would be impermissible for the bank itself" (*id.* at 64).

Since Congress thus undertook the regulation of bank affiliates so as to protect the affiliated banks and their depositors (see generally *ICI II*, 450 U.S. at 61) – and since affiliates otherwise are subject to less extensive regulation than banks under the Act – it would hardly make sense to read Section 20 as prohibiting affiliates from dealing in *bank-eligible* securities. But that is precisely the reading contended for by petitioner. Indeed, under petitioner's approach to Section 20, a bank would be precluded from moving its existing bank-eligible securities underwriting department into a separate, affiliated corporation, even

though the affiliate's only functions would be those currently being conducted by the bank. We cannot imagine—and petitioner does not suggest—any rationale for this result.

b. Petitioner nevertheless contends (Pet. 17-21) that its reading is compelled by the plain language of Section 20; in making this argument, petitioner notes that Section 20 refers generally to "securities" and does not contain the exception for bank-eligible securities that is written into Sections 16 and 21. As the court of appeals correctly explained, however, Congress's use of the word "securities" is not free of ambiguity. The original version of the Act referred to securities in three different ways: Section 16 distinguished bank-ineligible from bank-eligible securities; Sections 20 and 32 (as well as the original version of Section 21) referred to "securities" in general terms; and a since-repealed Section 19(e) referred to "securities *of any sort*" (12 U.S.C. (1964 ed.) 61(e) (emphasis added), *repealed, by* Act of July 1, 1966, Pub. L. No. 89-485, § 13(c), 80 Stat. 242-243). "That Congress chose three distinctively different ways to describe securities raises a red flag that cautions against declaring that the meaning of that term in § 20 is clear" (Pet. App. 14a). In addition, in 1935, two years after the adoption of the Act, Congress amended Section 21 to add the existing proviso authorizing banks to conduct bank-eligible securities activities. At the time, however, Congress made clear that it was simply clarifying what the phrase "stocks, bonds, debentures, notes, or other securities"—the same phrase that appears in Section 20—had meant from the beginning.[6] See S. Rep. 1260, 73d Cong., 2d Sess. 2 (1934); S. Rep.

[6] There was a particular need for legislative clarification of Section 21; it is a criminal provision that the Board declined to interpret authoritatively. See 20 Fed. Res. Bull. 543-544 (1934).

1007, 74th Cong., 1st Sess. 15 (1935); H.R. Rep. 742, 74th Cong., 1st Sess. 16 (1935); *Securities Industry Ass'n* v. *Board of Governors*, 807 F.2d 1052, 1058 (D.C. Cir. 1986), cert. denied, No. 86-1429 (June 19, 1987).[7]

In these circumstances, where the meaning of the statute is debatable, deference to the Board's construction is appropriate.[8] See, *e.g., Schwab*, 468 U.S. at 217; *ICI II*, 450 U.S. at 56; *Board of Governors* v. *Agnew*, 329 U.S. 441,

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[7] In arguing that the meaning of Section 20 is plain, petitioner relies (Pet. 18-20) principally on two of this Court's decisions, *Bankers Trust I* and *Board of Governors* v. *Dimension Financial Corp.*, 474 U.S. 361 (1986). Neither is relevant here. In *Bankers Trust I*, the Court examined the language (see 468 U.S. at 148-154) and purposes (see *id.* at 154-159) of the Act en route to concluding that commercial paper is a "security" within the meaning of Sections 16 and 21. The Court had no occasion to, and did not, address the relationship between the restrictions imposed on banks by those provisions and the restrictions imposed on bank affiliates by Section 20. *Dimension* held only that certain institutions are "banks" within the definition of that word set out in the BHCA. That holding – which involved a term that, in contrast to the one at issue here, is given an express definition in the applicable statute – plainly has no bearing on this case.

[8] Despite petitioner's hint to the contrary (Pet. 10-11), this Court has generally declined to review appellate decisions upholding reasonable agency interpretations of the Act. See *e.g., Securities Industry Ass'n* v. *Board of Governors*, 821 F.2d 810 (D.C. Cir. 1987), cert. denied, No. 87-562 (Jan. 11, 1988); *Securities Industry Ass'n* v. *Board of Governors*, 807 F.2d 1052 (D.C. Cir. 1986), cert. denied, No. 86-1429 (June 19, 1987); *Investment Company Institute* v. *FDIC*, 815 F.2d 1540 (D.C. Cir. 1987), cert. denied, No. 87-36 (Oct. 5, 1987); *Investment Company Institute* v. *Conover*, 790 F.2d 925 (D.C. Cir. 1986), cert. denied, 479 U.S. 939 (1986); *Investment Company Institute* v. *Clarke*, 793 F.2d 220 (9th Cir. 1986), cert. denied, 479 U.S. 939 (1986); *Investment Company Institute* v. *Clarke*, 789 F.2d 175 (2d Cir.), cert. denied, 479 U.S. 940 (1986); *Securities Industry Ass'n* v. *Comptroller of the Currency*, 758 F.2d 739 (D.C. Cir. 1985), cert. denied, 474 U.S. 1054 (1986), rev'd on other grounds, 479 U.S. 388 (1987).

450 (1947) (Rutledge, J., concurring). See generally *FDIC* v. *Philadelphia Gear Corp.*, 476 U.S. 426, 431 (1986). That is particularly true here, where the Board's lengthy orders—issued after a public hearing on the proposals—gave extensive consideration to petitioner's contentions, and where the Board's conclusion is entirely consistent with its longstanding view that bank holding companies may control nonbank subsidiaries that are engaged exclusively (and thus, necessarily, principally) in bank-eligible securities activities. See 12 C.F.R. 225.25(b)(16); *United Bancorp*, 64 Fed. Res. Bull. 222 (1978); *United Oklahoma Bankshares, Inc.*, 65 Fed. Res. Bull. 363 (1979); *Citicorp*, 68 Fed. Res. Bull. 249 (1982).[9]

[9] Petitioner contends (Pet. 21-23) that the Board's ruling here is inconsistent with its approach to Section 32, the provision of the Act that bars personnel interlocks between banks and firms that are "primarily engaged" in securities activities, "except in limited classes of cases in which the Board * * * may allow such service by general regulations." Because the Board believed in 1934 that it had to create an exception under Section 32 to permit interlocks between member banks and firms engaged in the distribution of bank-eligible securities, petitioner maintains that the Board must also have believed that the plain language of Section 20 applied to firms engaged in the bank-eligible securities business (Pet. 22, citing 20 Fed. Res. Bull. 485 (1934)). The point that is important for present purposes, however, is that—whatever its stated rationale—the Board has never treated bank-eligible securities operations as subject to the substantive restrictions of Section 32. Accordingly, the Board should not here be locked by analogy into a rationale it expressed more than 50 years ago in a very different context. As the courts have noted, in the Depression era regulators often took "an overcautious approach to bank regulation reflecting the atmosphere of the years immediately after the 1929 market crash." *New York Stock Exchange, Inc.* v. *Smith*, 404 F. Supp. 1091, 1097 (D.D.C. 1975), vacated on other grounds, 562 F.2d 736 (D.C. Cir. 1977), cert. denied, 435 U.S. 942 (1978). See *Securities Industry Ass'n* v. *Comptroller of the Currency*, 577 F. Supp. 252, 255 (D.D.C. 1983), aff'd, 758 F.2d 739 (D.C. Cir. 1985), cert. denied, 474 U.S. 1054 (1986).

2. Petitioner also (Pet. 23-24) takes issue with the holding below that a firm would not be "engaged principally" in securities activities when those activities do not exceed five to ten per cent of the firm's revenues. Petitioner appears to contend that any activity in which the firm engages "regularly" (Pet. 23) should be viewed as the firm's "principal[ ]" activity within the meaning of Section 20—even if that activity constitutes a wholly trivial proportion of the firm's business. But this assertion is flatly inconsistent with the language of Section 20, which makes it plain that bank affiliates may conduct bank-inelegible securities activities at some level. See *ICI II*, 450 U.S. at 64. Petitioner's real contention is that banks should not be permitted to affiliate at all with entities that engage to any extent in the securities business (see Pet. 11-15). As the court of appeals explained, however (Pet. App. 26a-27a), Congress rejected that approach when it worked the compromise that emerged in the Act, which limits, rather than eliminates, bank securities affiliates. See S. Rep. 77, 73d Cong., 1st Sess. 10 (1933).

Similarly without merit is petitioner's contention (Pet. 15-17, 23-24) that the Board adopted an improper " 'regulatory approach' " to the Act in its rulings in this case. It is true, of course, that the Board may not substitute a permissive regulation for a statutory prohibition. See *Bankers Trust I*, 468 U.S. at 153-154. But petitioner has offered no reason to believe that the Board acted improperly in setting a quantitative standard when it interpreted the inherently imprecise phrase "engaged principally." As the court below noted, "[t]he mere necessity of 'regulation' in carrying out Glass-Steagall's 'prohibitions' is insufficient to justify rejection of an otherwise reasonable interpretation of the Act" (Pet. App. 45a). "The Glass-Steagall Act does impose a system of flat 'prohibitions' and 'prophylactic' measures, * * * but this can-

not obviate the need to examine particular factual situations to determine on which side of the prohibitory line they fall." *Securities Industry Ass'n* v. *Board of Governors*, 807 F.2d at 1067.[10]

3. Finally, petitioner is incorrect in asserting (Pet. 16-17) that the Board's decision somehow displaces Congress in setting banking policy. Congress last year adopted legislation suspending the effective date of the Board's decision in this case until March 1, 1988 (Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, §§ 201(b)(2)(A), 203, 100 Stat. 581-582, 584); although Congress plainly was aware of the consequences, it has since allowed that moratorium to expire. Indeed, Congress is now considering legislation that would grant banks broad, new securities powers. On March 30, 1988, the Senate, by a vote of 94-2, passed a bill that (among other things) would repeal Section 20, the statutory provision whose meaning is disputed by petitioner. 134 Cong. Rec. S3437 (daily ed. Mar. 30, 1988).[11] The appropriate committees in the House are now considering similar bills. In these circumstances, it is petitioner's attempt to involve the Court in this case, and not the Board's decision, that threatens to interfere with Congress's legislative activities.

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[10] The particular regulatory restrictions attacked by petitioner (Pet. 23-24) were in fact adopted under the BHCA, not under the Act, as petitioner implies.

[11] The bill would permit bank affiliates to underwrite all bank-ineligible securities, except corporate stock, without regard to the existing "engaged principally" limitation.

CONCLUSION

The petition for a writ of certiorari should be denied.
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(5)

No. 87-1513

IN THE
Supreme Court of the United States

OCTOBER TERM, 1987

SECURITIES INDUSTRY ASSOCIATION,
Petitioner,

v.

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM, *et al.*,
Respondents.

**On Petition for a Writ of Certiorari
to the United States Court of Appeals
for the Second Circuit**

**BRIEF IN OPPOSITION FOR RESPONDENTS
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J.P. MORGAN & CO. INCORPORATED
AND CITICORP, *ET AL.***

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QUESTIONS PRESENTED

1. Does Section 20 of the Glass-Steagall Act limit the extent to which a bank affiliate may underwrite securities that Glass-Steagall authorizes a bank itself to underwrite without limitation?

2. Is a bank affiliate "engaged principally" in activities covered by Section 20 of Glass-Steagall if those activities account for less than 5% of its business?

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Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF IN OPPOSITION FOR RESPONDENTS BANKERS TRUST NEW YORK CORPORATION, J.P. MORGAN & CO. INCORPORATED AND CITICORP, *ET AL.*

Respondents Bankers Trust New York Corporation, J.P. Morgan & Co. Incorporated, Citicorp, The Chase Manhattan Corporation, Manufacturers Hanover Corporation, Chemical New York Corporation and Security Pacific Corporation (the "bank holding companies")[1]

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[1] A list of the subsidiaries (except wholly-owned subsidiaries) and affiliates of each of the respondent bank holding companies, as

respectfully request that this Court deny the petition for a writ of certiorari filed by the Securities Industry Association ("SIA") seeking review of the decision of the United States Court of Appeals for the Second Circuit in this case. *See* 839 F.2d 47 (1988) (Pet. App. 1a).[2]

STATEMENT OF THE CASE

In this case SIA challenges established legal principles that have been routinely and consistently applied for years by the Board of Governors of the Federal Reserve System (the "Board").

For the past decade, the Board has authorized nonbank subsidiaries of bank holding companies to underwrite and deal in U.S. Treasury securities, municipal general obligation bonds, and other securities that banks themselves may underwrite without limitation ("bank-eligible" or "governmental" securities). In its decision below, the Board construed the Glass-Steagall Act to permit a governmental securities subsidiary also to engage, to a limited extent, in underwriting certain kinds of securities that banks may not underwrite ("bank-ineligible" securities).

SIA's petition is based on a business concern that its members may be subjected to a small amount of additional competition in the markets for *bank-ineligible* securities. But the legal proposition at the heart of the rulings below is the Board's long-standing, and previously unchallenged, conclusion that Section 20 of the Glass-Steagall Act does not limit the extent to which bank affiliates may underwrite *bank-eligible* securities such as

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required by Rule 28.1 of the Rules of the Supreme Court, is attached as Appendix A. None of the respondent bank holding companies has a parent corporation.

[2] The Petition for Writ of Certiorari and the Appendix to the Petition are cited herein as "Pet. ——" and "Pet. App. ——."

U.S. Treasury bonds. This is the only *legal* issue that SIA seriously addresses in its petition for review.[3]

The Glass-Steagall Act. Congress passed the Glass-Steagall Act to protect banks and their depositors from the risks Congress perceived to be associated with bank involvement in certain securities activities. To this end, Sections 16 and 21 of the Act generally prohibit banks from underwriting securities to any extent.[4] But these provisions expressly permit banks to underwrite U.S. Treasury securities, municipal general obligation bonds, and certain other governmental securities. Congress permitted banks to underwrite these "bank-eligible" securities without restriction because bank participation in these

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[3] SIA's petition is consistent with its well-established practice of using litigation to stave off for as long as possible *any* threat to the competitive position of its members. SIA's insistence that this case "is of enormous national significance to the financial markets throughout the country," Pet. 10, is also consistent with its practice of overstating the importance of cases it presents for review. In its recent petition for review in *Securities Industry Ass'n v. Board of Governors*, 821 F.2d 810 (D.C. Cir. 1987), *cert. denied*, 56 U.S.L.W. 3459 (1988), for example, SIA made its standard "national significance" argument, but after this Court denied SIA's petition the following report appeared:

> "The Securities Industry Association expressed disappointment last week with the Supreme Court's refusal to hear a case involving National Westminster Bank, but said the importance of the case has diminished since the suit was first filed. The main arena for action on expanded securities powers for banks is now in Congress, where several Glass-Steagall reform bills are pending, SIA said."

"SIA Downplays Supreme Court's Refusal to Hear NatWest Case," *Securities Week*, Jan. 18, 1988 at 11.

[4] By its terms, Section 16, 12 U.S.C. § 24 (Seventh), governs the activities of national banks. Section 5(c) of the Banking Act of 1933 extends the provisions of Section 16 to state-chartered banks that are members of the Federal Reserve System ("member banks"). *See id.* at § 335. Section 21, *id.* at § 378, effectively extends the provisions of Section 16 to state-chartered banks that are not member banks.

markets serves the public interest and because Congress concluded that the underwriting of these governmental securities poses no significant threat to the interests of depositors or the stability of banks. *See Securities Industry Ass'n v. Board of Governors*, 468 U.S. 137, 157 (1984) (*"Bankers Trust I"*).

Section 20 of Glass-Steagall complements the restrictions imposed by Sections 16 and 21 by limiting the securities activities of bank affiliates (in this case, companies owned by companies that also own a bank). While Sections 16 and 21 prohibit banks from underwriting "bank-ineligible" securities *to any extent whatsoever*, Section 20 prohibits bank affiliates only from being "*engaged principally*" in such underwriting.[5] As this Court has recognized, the "engaged principally" standard is less stringent than the standard that applies to banks, and permits bank affiliates to engage in securities "activities that would be impermissible for the bank itself." *Board of Governors v. Investment Co. Inst.*, 450 U.S. 46, 64 (1981) ("ICI *II*").

In interpreting Section 20, the Board has consistently authorized bank affiliates to engage without limitation in the underwriting of bank-eligible securities.[6] In 1984

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[5] Section 20, 12 U.S.C. § 377, prohibits affiliations between member banks and firms that are "engaged principally" in the "issue, flotation, underwriting, public sale, or distribution" of "stocks, bonds, debentures, notes, or other securities." For convenience, these activities are referred to herein as "underwriting." Each of the bank holding companies involved in this case owns at least one member bank.

[6] The Board issued its first such authorization in 1978, and has issued numerous authorizations since then. *See Manufacturers Hanover Corp.*, 70 Fed. Res. Bull. 661 (1984); *Orbanco Financial Services Corp.*, 69 Fed. Res. Bull. 465 (1983); *Citicorp*, 68 Fed. Res. Bull. 249 (1982); *United Oklahoma Bankshares, Inc.*, 65 Fed. Res. Bull. 363 (1979); *Stepp, Inc.*, 64 Fed. Res. Bull. 223 (1978); *United Bancorp*, 64 Fed. Res. Bull. 222 (1978). In its decision below, the Board reiterated that these authorizations were based

the Board unanimously adopted a regulation specifically adding bank-eligible securities underwriting to its "laundry list" of permissible activities for nonbank subsidiaries of bank holding companies.[7] That regulation was adopted without challenge from SIA or anyone else.

The Applications In This Case. Beginning in 1985, each of the bank holding companies sought Board approval under the Bank Holding Company Act, 12 U.S.C. § 1841 *et seq.*, for one of its wholly-owned nonbank subsidiaries to engage generally in underwriting bank-eligible securities and, to a limited extent, in underwriting certain bank-ineligible securities, including commercial paper and certain municipal revenue bonds.[8] To assure compliance with Section 20 of Glass-Steagall, each of the bank holding companies proposed to limit the bank-ineligible securities underwriting activities of its subsidiary so that the subsidiary would not be "engaged principally" in such activities.

The Board's Decision. The Board reviewed the bank holding companies' applications for more than two years, solicited public comments, and conducted a public hearing.[9] On April 30, 1987, the Board issued a detailed 120-page order approving the applications.

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on its legal conclusion that bank-eligible securities underwriting "is not the type of activity prohibited by section 20 . . . of the Glass-Steagall Act." Pet. App. 69a.

[7] *See* 48 Fed. Reg. 23520, 23530-32 (May 25, 1983) (notice of rulemaking); 49 Fed. Reg. 794, 816, 826-28 (Jan. 5, 1984) (final rule) (codified at 12 C.F.R. § 225.25(b)(16)).

[8] Some of the bank holding companies had previously obtained Board approval to establish wholly-owned nonbank subsidiaries to underwrite bank-eligible securities. *See, e.g., Citicorp*, 68 Fed. Res. Bull. 249 (1982).

[9] The record before the Board shows that the bank holding companies' applications were triggered by dramatic changes in the financial services marketplace in recent years. Traditional banking activities such as making short-term loans and underwriting municipal general obligation bonds have been replaced to a significant

The Board considered and rejected all the arguments advanced by SIA. First, the Board rejected SIA's contention that Section 20 limits the extent to which a bank affiliate may underwrite bank-eligible securities. Based on a detailed examination of its prior interpretations of Section 20 and of the language, structure and legislative history of the Glass-Steagall Act, the Board reaffirmed its long-standing conclusion that Section 20 does not restrict a bank affiliate's underwriting of bank-eligible securities.

The Board also rejected a second, and distinct, Glass-Steagall argument advanced by SIA. SIA contended that the bank affiliates would be "engaged principally" in underwriting bank-ineligible securities if such underwriting was a "regular" activity of the affiliates, even if it accounted for only a small part of their business. Based on long-standing interpretations of the phrase "engaged principally" and related language in the Glass-Steagall Act, the Board rejected SIA's contention and concluded that a "bank affiliate may underwrite and deal in [bank-ineligible securities], provided that this line of business does not constitute a principal or substantial activity for the affiliate." Pet. App. 59a. In this connection, the Board restricted each affiliate's gross revenues from underwriting and dealing in bank-ineligible securities to a maximum of 5% of the affiliate's total gross revenues. Pet. App. 84a-85a.[10]

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degree by activities in which banks themselves may not engage, such as underwriting commercial paper and municipal revenue bonds. *See, e.g.*, Board of Governors of the Federal Reserve System, *Flow of Funds Accounts* (Sept. 1986); *Profitability of Insured Commercial Banks in 1984*, 71 Fed. Res. Bull. 836, 848 (1985). This surge in the "securitization" of traditional banking services led the bank holding companies to seek Board approval to engage in the limited bank-ineligible securities underwriting permitted by Section 20.

[10] The Board stated that it would review this restriction within one year "to assess whether somewhat higher levels of activity up to 10 percent may be permissible consistent with [its] interpreta-

Finally, the Board determined that limited underwriting of bank-ineligible securities is also permissible under Section 4(c)(8) of the Bank Holding Company Act, 12 U.S.C. § 1843(c)(8).[11] The Board found that this activity is "a natural extension of activities currently conducted by banks, involving little additional risk or new conflicts of interest." Pet. App. 89a. It also concluded that the "introduction of new competitors into these markets may be expected to reduce concentration levels and, correspondingly, to reduce financing costs, underwriting spreads, and increase the availability of services to issuers." Pet. App. 96a. The Board imposed numerous limitations on the conduct of the approved activities in order "to assure that the [activities] will not produce significant conflicts of interest, unsound banking practices, unfair or decreased competition, undue concentration of resources or other adverse effects." Pet. App. 73a (footnote omitted); *see also* Pet. App. 128a-134a. The Board's determinations under the Bank Holding Company Act were not disputed before the Court of Appeals and are not challenged in SIA's petition for certiorari.

The Court of Appeals' Decision. On February 8, 1988, the United States Court of Appeals for the Second Circuit unanimously rejected SIA's challenge to the Board's

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tion of the term engaged principally as encompassing any activity that is substantial." Pet. App. 84a-85a.

[11] Section 4(c)(8) requires a bank holding company to obtain the approval of the Board prior to acquiring, establishing, or expanding the activities of a nonbank subsidiary. As a predicate to granting such approval, the Board must determine that the activities to be conducted by the nonbank subsidiary are "so closely related to banking . . . as to be a proper incident thereto." The "proper incident" test requires the Board to "consider whether [the performance of the proposed activities] by an affiliate of a holding company can reasonably be expected to produce benefits to the public . . . that outweigh possible adverse effects . . . ." 12 U.S.C. § 1843(c)(8).

decision. The Court of Appeals held that Section 20 does not "preclude a bank affiliate from engaging in the same activities to the same extent as a member bank" and upheld the Board's determination that "the reference in § 20 to 'securities' does not encompass those securities which § 16 allows banks themselves to underwrite." Pet. App. 36a-37a. The Court of Appeals also unanimously rejected SIA's contention that the government securities subsidiaries would violate the "engaged principally" standard by deriving 5% of their business from bank-ineligible underwriting. Pet. App. 43a-45a.

REASONS FOR DENYING THE WRIT

I. THE DECISIONS BELOW RAISE NO IMPORTANT QUESTION OF LAW WARRANTING THIS COURT'S REVIEW

The Board is the agency charged by Congress with the task of determining whether bank affiliates may conduct the securities activities at issue here. After extensive deliberation, the Board concluded that these activities do not infringe, and are indeed consistent with, the language, structure and legislative history of the Glass-Steagall Act. The Court of Appeals has agreed with the Board and no other court has taken a contrary position.

The decisions below simply confirm the decade-old rule that Section 20 of Glass-Steagall does not limit the extent to which a bank affiliate may underwrite bank-eligible securities. As the Board and the Court of Appeals determined, SIA's contrary interpretation of Section 20 improperly divorces the words of the statute from their context and disregards the structure and legislative history of the Act. To suggest, as SIA does, that Glass-Steagall permits the underwriting of government securities in a bank *department*, but restricts the underwriting of such securities in a bank *affiliate*, defies common sense and is flatly inconsistent with congressional intent and this Court's precedents. Indeed, this Court has held

that Section 20 reflects an express congressional decision to permit a bank affiliate to engage in securities "activities that would be impermissible for the bank itself." *ICI II*, 450 U.S. at 64.

SIA also half-heartedly advances the argument that Section 20 bars a bank affiliate from deriving even a limited percentage of its total business from underwriting bank-ineligible securities. That meritless argument was rejected unanimously by both the Board and the Court of Appeals. This Court has already held that the "engaged principally" standard in Section 20 establishes a "significantly less stringent test for determining the permissibility of securities-related activity [conducted by bank affiliates] than does the word 'engaged,' contained in [the sections of the Act] applicable to banks." *Id.* at 71 n.46. In the face of this authority, SIA's contention that a bank affiliate is "engaged principally" in activities covered by Section 20 even if those activities account for less than 5% of its total business is simply untenable. SIA itself implicitly acknowledges the weakness of its position by devoting only a few lines of its legal analysis to this question.[12]

[12] SIA tries to infuse significance into this case by raising the spectre of affiliations between member banks and the largest investment banks in the country. This is completely irrelevant to the decisions below, which approve only a small amount of bank-ineligible underwriting through *de novo* nonbank subsidiaries. Moreover, any transaction producing an affiliation between a bank and an investment bank would be subject to the Board's prior approval under Section 4(c)(8) of the Bank Holding Company Act. The Board would have to determine that each and every activity in which the investment bank was engaged was "closely related to banking" and that the proposed transaction satisfied the "net public benefits" test under Section 4(c)(8). In short, it is nonsense for SIA to suggest that the decisions below permit affiliations between commercial banks and the largest investment banks in the country.

Congress is fully aware of the Board's decision. Last year it adopted legislation that suspended the effective date of the Board's decision until March 1, 1988 while new financial services legislation was being considered.[13] Congress has now allowed the moratorium to lapse, thereby eliminating any legislative barrier to the Board's decision taking effect. The proper conclusion to be drawn from these legislative developments is *not* that Congress regards the Board's decision as an invasion of its prerogatives, but that Congress is content to let the Board's decision take effect while it continues to consider new legislation. Indeed, on March 30, 1988, the Senate approved by a vote of 94-2 legislation that would *repeal* Section 20 of Glass-Steagall and permit bank affiliates to engage *without limitation* in underwriting *all* bank-ineligible securities except corporate stock.[14]

II. THE DECISIONS BELOW ARE PLAINLY CORRECT AND FULLY CONSISTENT WITH THIS COURT'S PRECEDENTS

A. Section 20 Does Not Restrict a Bank Affiliate's Underwriting of Bank-Eligible Securities

Section 20 prohibits affiliations between member banks and firms engaged principally in the underwriting of "stocks, bonds, debentures, notes, or other securities." Because the Glass-Steagall Act does not define these terms, the Board and the Court of Appeals employed the traditional methods of statutory construction to determine their meaning. Based on an exhaustive review of the language, structure and legislative history of the Act, the Board and the Court of Appeals confirmed the decade-old determination that Section 20 does not limit

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[13] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, §§ 201(b)(2)(A), 203.

[14] *See* 134 Cong. Rec. S3437 (daily ed. March 30, 1988). The Senate bill requires Congress to vote on or before April 1, 1991 on whether to permit bank affiliates to underwrite corporate stock. *See* S. Rep. No. 305, 100th Cong., 2d Sess. at 73 (1988).

the extent to which a bank affiliate may underwrite bank-eligible securities. Both the Board and the Court of Appeals were unanimous on this point.[15]

This ruling is straightforward and plainly correct. Glass-Steagall restricts banks' underwriting activities in order to protect banks and their depositors from risks Congress perceived to be associated with banks' involvement in certain securities activities.[16] But the Act expressly permits banks to underwrite bank-eligible securities. If, as Congress decided, underwriting bank-eligible securities is safe enough to be permissible for a bank itself, it must be equally permissible for a bank affiliate, since the only reason Congress restricted the activities of bank affiliates was to provide additional protection for banks.[17]

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[15] The two dissenters from the Board's decision (former Chairman Volcker and Governor Angell) expressly stated that they supported "earlier Board decisions allowing the underwriting and dealing of [bank-eligible] securities to take place in an affiliate." Pet. App. at 127a n.2. The dissent was based on an entirely different theory, which not even SIA embraces or defends. The dissenters argued that if a bank affiliate underwrites even a small amount of bank-ineligible securities, its otherwise permissible bank-eligible underwriting is somehow transformed into an activity limited by Section 20. Pet. App. 136a-137a. The dissenters offered no legal analysis or authority to support their position.

[16] *See, e.g., ICI II*, 450 U.S. at 53 ("Congress placed restrictions on the securities-related business of banks in order to protect their depositors").

[17] As the Court of Appeals stated: "Because underwriting and dealing in [bank-eligible] securities pose no hazards to banks themselves, *a fortiori* bank affiliates should be able principally to engage in the same activity." Pet. App. 36a. *See Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 207, 221 (1984) (*"Schwab"*) ("[T]he fact that § 16 . . . allows banks to engage directly in [an activity] suggests that the activity was not the sort that concerned Congress in its effort to secure the Nation's banks from the risks of the securities market").

SIA has tried to argue that Section 20 imposes a more restrictive standard on the securities activities of bank affiliates than on those of banks themselves. But that makes no sense, and this Court has already held that bank affiliates can engage in securities "activities that would be impermissible for the bank itself." *ICI II*, 450 U.S. at 64. Thus, as the Justice Department advised the Board in its comments during the administrative process, SIA's contention that bank affiliates are more constrained in their securities activities than banks themselves "stands the statutory scheme on its head." [18]

The legislative history confirms that the Act was not intended to limit the extent to which a bank affiliate may underwrite bank-eligible securities:

> "Mr. LONG. I have been told that the Senator has said that he did not think this bill would prohibit the handling of Government and State bonds by the . . . banks, *that the Senator's provision against affiliates handling bonds was not intended to affect the handling of Government and State bonds.*
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> MR. GLASS. They are expressly excluded from the terms of the bill." [19]

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[18] Department of Justice Comments, Appendix B hereto at 12a n.23. *See also* Pet. App. 35a (Court of Appeals) ("Since banks are allowed under § 16 to underwrite and deal in government obligations without limitation, it would be incongruous for § 20 to prohibit banks from affiliating with entities that are merely 'engaged principally' in those same activities"); Comptroller of the Currency Comments, Appendix C hereto.

[19] 76 Cong. Rec. 2000 (1933) (emphasis added). SIA argued that other parts of the exchange between Senator Long and Senator Glass supported its position, but the Court of Appeals expressly rejected that contention:

> "Senator Glass' response to Senator Long indicates that he was primarily concerned with 'back door' arrangements between banks and their security affiliates that permitted affiliates to engage in the securities business denied by law to the bank itself. Senator Glass' reservation did not encompass affiliate

Based on this and other evidence in the legislative history, the Court of Appeals concluded that "Congress' concern was primarily with bank affiliate activities in bank-ineligible securities." Pet. App. 30a. Congress did not intend to, and did not, restrict a bank affiliate's underwriting of governmental securities.

Further confirmation of this understanding is provided by Congress' clarification in 1935 of the meaning of the phrase "stocks, bonds, debentures, notes, or other securities." This phrase appears in *both* Section 21 of Glass-Steagall, which applies to banks, and in Section 20, which applies to bank affiliates. After Glass-Steagall was adopted in 1933, some questions arose about the meaning of this phrase in Section 21, which unlike Section 20 was a criminal statute.[20] Accordingly, in 1935 Congress added a proviso to Section 21 to make it absolutely clear that bank-eligible securities were not encompassed by the phrase "stocks, bonds, debentures, notes, or other securities." The identical phrase in Section 20 necessarily has always had the same meaning.[21]

> activity in a business that § 16 grants to a bank 'the privilege of doing.'"

Pet. App. at 29a. Although Senator Glass objected generally to bank affiliates, Congress did not adopt his view that they should be abolished.

[20] The Board took the position that it would not provide authoritative interpretations of Section 21 because it was a criminal provision. *See, e.g.*, 20 Fed. Res. Bull. 542, 543-44 (1934).

[21] The 1935 amendment added new language to Section 21 that was not included in Section 20. But in both the Senate and House reports Congress made it clear that the proviso to Section 21 was added not to *change* what Section 21 meant, but to *clarify* what the phrase "stocks, bonds, debentures, notes, or other securities" had meant all along. S. Rep. No. 1260, 73d Cong., 2d Sess. 2 (1934); S. Rep. No. 1007, 74th Cong., 1st Sess. 15 (1935); H.R. Rep. No. 742, 74th Cong., 1st Sess. 16 (1935). Both the Second Circuit below, and the D.C. Circuit in an earlier decision, have unani-

SIA's attack on the Board's and the Court of Appeals' construction of Section 20 relies mainly on *Bankers Trust I* and *Board of Governors v. Dimension Financial Corp.*, 474 U.S. 361 (1986) ("*Dimension*"). To the extent that *Bankers Trust I* and *Dimension* are pertinent, they support the decisions below.[22] Indeed, in *Bankers Trust I*, this Court specifically stated that Congress' concern about a bank's establishing a "securities operation" did not extend to "governmental obligations that Congress specifically has chosen to favor." 468 U.S. at 158. Moreover, this Court's analysis in both cases confirms that the Board and the Court of Appeals correctly examined the structure and legislative history of Glass-Steagall as well as the specific statutory terms in determining what Congress had intended. In fact, in every Glass-Steagall case this Court has decided, it has thoroughly examined the structure and legislative history of the Act, just as the Board and the Court of Appeals did here.[23]

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mously confirmed that the 1935 amendment merely clarified the statutory phrase and did not change its meaning in any way. *See* Pet. App. 33a; *Securities Industry Ass'n* v. *Board of Governors*, 807 F.2d 1052, 1058 (D.C. Cir. 1986), *cert. denied*, 107 S. Ct. 3228 (1987) ("*Bankers Trust II*") (holding that Congress' 1935 amendment to Section 21 "sought merely to *clarify*" the statute and that the statutory language "necessarily" had the same meaning both before and after the amendment) (emphasis in original).

[22] *Bankers Trust I* simply held that a certain form of corporate debt (commercial paper) is a "security" that Glass-Steagall bars *banks* from underwriting; it provides no support for SIA's contention that a bank affiliate's ability to underwrite bank-eligible securities is more limited than that of a bank. *Dimension* involved the definitional sections of the Bank Holding Company Act.

[23] *See Schwab*, 468 U.S. at 214-21; *Bankers Trust I*, 468 U.S. at 144-60; *ICI II*, 450 U.S. at 61-68; *Investment Co. Inst. v. Camp*, 401 U.S. 617, 623-39 (1971); *Board of Governors v. Agnew*, 329 U.S. 441, 447-49 (1947).

Finally, SIA relies on the Board's interpretation of Section 32 of the Glass-Steagall Act, a provision not at issue in this case that prohibits personnel interlocks between member banks and firms that are "primarily engaged" in securities underwriting. SIA suggests that because the Board created an exemption under Section 32 for firms engaged in bank-eligible underwriting, the Board must have thought that this activity was covered by Section 20. Pet. 21-23. But the Board has long adhered to the "view that the conduct of [bank-eligible underwriting] by member bank affiliates is not the type of activity prohibited by *section 20 or 32* of the Glass-Steagall Act." Pet. App. 69a (emphasis added).[24] In light of the Board's clear position on this issue, the fact that the Board has taken a "belt and suspenders" approach by also relying on its exemptive authority under Section 32 is irrelevant.[25]

In short, SIA's attack on the rulings below is undermined not only by the weakness of its specific arguments,

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[24] The Board's own regulatory handbook explains that Section 32 does not apply to organizations "involved only in 'government' securities transactions." Federal Reserve Regulatory Service 3-866.

[25] The courts have recognized that bank regulators frequently took an unnecessarily cautious approach to Glass-Steagall issues immediately after the Act's adoption. *See New York Stock Exchange* v. *Smith*, 404 F. Supp. 1091, 1097 (D.D.C. 1975), *vacated on other grounds sub nom. New York Stock Exchange* v. *Bloom*, 562 F.2d 736 (D.C. Cir. 1977), *cert. denied sub nom. New York Stock Exchange v. Heimann*, 435 U.S. 942 (1978) (accepting Comptroller's position that early construction of Glass-Steagall embodied "an overcautious approach to bank regulation reflecting the atmosphere of the years immediately after the 1929 market crash" rather than the legislative history of the Act). *Accord Securities Industry Ass'n* v. *Comptroller of Currency*, 577 F. Supp. 252, 255 (D.D.C. 1983), *aff'd*, 758 F.2d 739 (D.C. Cir. 1985), *cert. denied*, 474 U.S. 1054 (1986) (rejecting SIA's reliance on early Comptroller opinions restrictively interpreting Section 16 that were subsequently repudiated by the Comptroller).

but also by its failure to offer *any* plausible explanation of why Congress would have imposed more severe restrictions on the governmental securities activities of bank affiliates than it imposed on those of banks themselves.

B. Section 20 Permits a Bank Affiliate to Derive a Limited Percentage of Its Total Business from Underwriting Bank-Ineligible Securities

SIA makes a passing suggestion in its petition that a bank affiliate is "engaged principally" in underwriting bank-ineligible securities even if that activity accounts for less than 5% of the affiliate's business. That contention was rejected in the decisions below as patently inconsistent with this Court's precedents and with the language, structure and legislative history of the Glass-Steagall Act.

This Court decided in *ICI II* that the "engaged principally" standard in Section 20 establishes a "significantly less stringent test for determining the permissibility of securities-related activity than does the word 'engaged,' contained [in the sections of the Act] applicable to banks." 450 U.S. at 71 n.46. As the Court of Appeals concluded, Congress' decision to employ the "engaged principally" standard was deliberately made with full knowledge that it would permit bank affiliates to engage in some considerable amount of bank-ineligible securities activities.[26] Against this background, the Board and the

[26] Pet. App. 27a. The Court of Appeals noted that Senator Bulkley, "one of the leading advocates of Glass-Steagall," was well aware that the word "engaged" connoted a stricter standard than the words "engaged principally": he successfully offered an amendment to delete the word "principally" from Section 21 (which applies to banks) because he feared it would allow banks to engage to a substantial extent in bank-ineligible activities. In this light, the Court of Appeals concluded that "it is inconceivable that [the word 'principally'] could remain in § 20 by sheer happenstance." *Id.*

Court of Appeals were compelled to reject SIA's contention that a bank affiliate is "engaged principally" in any activity in which it engages "regularly" even if the activity accounts for less than 5% of the affiliate's business.[27]

SIA argues that the rulings below are inconsistent with Congress' intention to abolish the "security affiliates" of commercial banks and that they create a "loophole" in the Glass-Steagall Act. Pet. 23. In fact, as the Senate committee report accompanying the Glass-Steagall Act explained, Congress expressly *rejected* proposals to abolish security affiliates. Instead, Congress chose to separate security affiliates "as far as possible" from member banks, to restrict credit transactions between banks and their affiliates, and to provide for the examination of affiliates.[28] In light of these safeguards, Congress chose to permit bank affiliates to engage in securities "activities that would be impermissible for the bank itself," *ICI II*, 450 U.S. at 64, so long as the affiliate is not "engaged principally" in those activities. As the Board explained, this limitation assures that bank affiliates cannot become "the type of general securities underwriting affiliates Congress intended to divorce from member banks in 1933." Pet. App. 72a.

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[27] The question presented by SIA's petition is whether the Board and the Court of Appeals properly rejected SIA's extremely restrictive interpretation of the "engaged principally" standard. The Board's interpretation of "engaged principally" is, in fact, very conservative, but the question of the outer limits of the standard is not before the Court.

[28] S. Rep. No. 77, 73d Cong., 1st Sess. at 10 (1933). Based on this and other evidence in the legislative history, the Court of Appeals concluded that "while the original impetus behind the Glass-Steagall bill . . . may have been to sever completely the commercial and investment banking industries, it fell short of that goal—a victim of legislative compromise." Pet. App. 27a.

SIA's final contention is that "the court of appeals allowed the Board again 'effectively [to] convert a portion of the [Glass-Steagall] Act's broad prohibition into a system of administrative regulation' . . ." Pet. at 24 (quoting *Bankers Trust I*, 468 U.S. at 153). This argument badly distorts the decisions below. The Board imposed prudential limitations on the activities of the bank affiliates pursuant to Section 4(c)(8) of the Bank Holding Company Act, 12 U.S.C. § 1843(c)(8). These restrictions are not based on the Glass-Steagall Act at all. Pet. App. 73a. Indeed, the Board specifically noted that the limitations and conditions in its orders relating to lending arrangements, sharing of office space and the like went "further than Congress under the Glass-Steagall Act." *Id.* SIA has not challenged the Board's authority to impose these limitations under the Bank Holding Company Act.

CONCLUSION

For all of the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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Dated: May 13, 1988

APPENDICES

APPENDIX A

Pursuant to Rule 28.1 of this Court, the subsidiaries (except wholly-owned subsidiaries) and affiliates * of each of the respondent bank holding companies are identified below. None of the respondent bank holding companies has a parent corporation.

Bankers Trust New York Corporation:

Subsidiaries and Affiliates:

Sumgin Bankers Investment
BT Asia Securities Limited
Banco Iochpe de Investimento
IM Trust & Co.
PT Bankers Trust Lippo Leasing
Turk Merchant Bank A.S.
BT Brokerage & Associates Pte. Ltd.
Provide
Thai Investment & Securities Co. Ltd.

J.P. Morgan & Co. Incorporated:

Subsidiaries and Affiliates:

J. P. Morgan Securities Asia Ltd.

Citicorp:

Subsidiaries and Affiliates:

Administradora de Consorcios Crefisul Ltda.
Advanced Technical Systems Limited
Agence Touristique de Guyenne et Gascogne S.A.
Ambac Inc.
Apetik-Refeicoes Convenio Ltda.
Aportes y Suministros S.A.
Argos Companhia de Seguros
Arrendadora Inci, S.A. de C.V.

* For this purpose, a "subsidiary" or an "affiliate" is a company more than 25% of the voting securities of which are owned by a respondent bank holding company.

Arrendadora y Administradora Citycol S.A.
Auximar Voyages S.A.
Banco Crefisul de Investimento S.A.
Banco de Honduras S.A.
Banco Internacional de Colombia (Nassau) Limited
Banco Internacional de Colombia, S.A.
Bay Forest Lot 20
Boerum Court Associates
Brickell Biscayne Associates
BT Publications, Inc.
Bytex Holdings Limited
C.R.P.-Representacoes, Comercio e
Participacoes Ltda.
Camelot Partnership
Cardholder Services Limited
Central Holdings Corporation
CFM Incorporated
Channel Collections Limited
Citi-Alexis Partnership Limited
Citi-Fairway Partnership Limited
Citi-Little Partnership Limited
Citi-Renaissance Partnership Limited
Citi-Reserve, Societe D'Investissement a
Capital Variable
Citibank (Zaire) S.A.R.L.
Citibank Budapest RT
Citibank Espana S.A.
Citibank Financial Consultants Limited
Citibank Italia S.p.A.
Citibank-Maghreb
Citicorp y Rio—Banco de Inversion, S.A.
Citifin Espana, S.A. de Financiacion
Citifinance Limited
Citilease Internacional, S.A.
Citilease Syndication No. 1 Corp.
Citilife S.A.N.V.
Citytrust Banking Corporation
Citytrust Finance Corporation

Citytrust Insurance Brokers Corporation
Citytrust Investment Philippines, Inc.
Clarke Vickers (UK) Limited
CNR Partners
Collateral Trust Corporation Limited
Cominter, Groupement d'Interet Economique Regi
Par L'Ordonnance du 23
Compagnie Franco-Americaine de Gestion Financiere
Compagnie Generale de Banque Citibank
Compania Colombiana de Financiamiento
Comercial S.A.
Compania Exportadora Cityexport S.A.
Credicard S.A.—Administradora de
Cartoes de Credito
Crefidata S.A.—Processamento de Dados
Crefisul—Arrendamento Mercantil S.A.
Crefisul—Corretora de Seguros Ltda.
Crefisul—Previdencia Privada S.A.
Crefisul Comercio e Exportacao Ltda.
Crefisul Commodities Ltda.
Crefisul Distribuidora de Titulos e
Valores Mobiliarios S.A.
Crefisul Empreendimentos Imobiliarios S.A.
Crefisul S.A.—Credito, Financiamento
e Investimentos
Crefisul—Promotora de Vendas Ltda.
D.C. The Credit Managing & Marketing Co., Ltd.
D.C.F. Services Limited
Dalgety Rural Finance Limited
Datatype International Limited
DCF Holding S.A.
DHC Corporation
Diners Assurances S.A.R.L.
Diners Club de France S.A.
Diners Club du Maroc
Diners Club Israel Limited
Diners Club Limited (Australia)
Diners Club Limited, The (England)
Diners Club Limited, The (Ireland)

Diners Club of Japan, Inc., The
Diners Selection S.A.R.L.
Diners Voyages S.A.
Diners World Travel Limited
Diners World Travel Ltd.—Greece
Diners World Travel Pty. Limited
DKM Consultants Limited
DNC Agency, Inc.
Dorchester on Rittenhouse Square Partners, The
Eagle II
Elogica Gesellschaft fur Elektronik in Der Datenubertragung M.b.H.
Empresa de Colaboraciones Comerciales, S.A.
European Industrial Services Limited
Famibank S.A.
Financia Nederland N.V.
Finders Limited
First Citicorp Leasing, Inc.
First Interlaken Corp.
First National Nippon Shinpan Co., Ltd.
Fraser Vickers Research Pte. Limited
Garfield Restoration, The
Getco S.A.R.L.
Giftworld Holdings Limited
GKB Gerwerbekreditbank AG
GKB Leasing GmbH
Goldsboro Joint Venture
Greater Southwest Community Service Corp.
Harrison Credit Group, Inc.
HCG Services, Inc.
Heidelberger Inkasso Bappert KG
Industrias Reliance, S.A. de C.V.
Informacao e Technologia S.A.
Inmobiliaria Jiennense, S.A.
Integrated Ceramic Components Limited
Inversiones en Financiamiento S.A.
Island Finance Corporation
J & E Davy

J & E Davy Holdings Limited
J.J. Finance Pty. Limited
J.N. Travers & Co. Limited
KKB Bank AG
KKB Finanzberatung GmbH
KKB Lebensversicherung AG
Lake Terrace Associates
Leasecontracts P.L.C.
Lenox Mexicana, S.A. de C.V.
Lensfield Products Limited
Lexington Commons, The
Lexington Village, The
Maghreb Finance S.A.
Mandata GmbH fur Rechtsbesorgung und Inkasso
Managers Holdings Limited
Marine Partners
Memo Services S.A.R.L.
Meridia Finanziaria S.P.A.
Meridia Leasing S.P.A.
Meridian Partnership Ltd.
Mission Park Corporation
Negofia Investissements S.A.
Newnet S.A.
Nigeria International Bank, Limited
Norper Investments Pty. Limited
Ogisec S.A.R.L.
Olive Trees Venture
One Sansome Street Associates
P.T. Citicorp Leasing Indonesia
Paddle Creek Enterprises, Inc.
Papago Ridge Joint Venture
Partridge Hill Company
Planlife Advisory Services Limited
PPLA Plaza, A Limited Partnership
Provequim, S.A. de C.V.
Revue Signature S.A.
Riba—Representacoes Participacoes e
Administracao Ltda.

Rochford Thompson Group Limited
S.N.—Crefisul S.A.—Distribuidora de Titulos e Valores Mobiliarios
S.N.—Crefisul S.A.—Sociedade Corretora
Sansome Land Associates
Saudi American Bank
Schuyler Associates
SCI Buc Les Yvelines
SCI Sainte Madeleine I
SCI Sainte Madeleine II
SCI 101-103 Boulevard Pereire
Scrimgeour Vickers Financial Services Limited
Serfia S.A.
Sita World Travel (London) Limited
Sobelfac S.A.
Spar-und Kreditbank Registrierte Genossenschaft MbH
Spectrum Itex Limited
Sperry New Holland Credit Corporation
Storecard Limited
Sulina-Participacoes e Servicos Ltda.
Sur Seguros de Retiro y Vida S.A.
Taiwan First Investment and Trust Co., Ltd.
Texas AP Inc.
Tiers of Laurel Lakes Limited Partnership, The
Tintawn Carpets Limited
Tupuna Unit Trust, The
United Bank of Trinidad and Tobago Limited, The
United News Shops Holdings Limited
Veda Credit & Travel Services Ltd.
Wattana Associates Company Limited
808 Broadway Associates

The Chase Manhattan Corporation:

Subsidiaries and Affiliates:

3405 Greenway Associates
3507 N. Charles Street Associates
Banco Chase Manhattan, S.A.

Calvert Executive Plaza, Ltd.
Chase AMP Acceptances Ltd.
Chase AMP Bank Ltd.
Chase AMP Capital Markets Ltd.
Chase AMP Futures Ltd.
Chase AMP Nominees Ltd.
Chase AMP Properties Ltd.
Chase Bank Cameroon, S.A.
Chase Banque de Commerce
Chase Gestoni S.P.A.
Chase Manhattan Bank Espana, S.A.
Chase Manhattan Leasing, S.A.
Chase Manhattan S.A. Credito Financiamento Investimento LMS Imoveis Limitada
Chase Manhattan S.A. Distribuidora de Titulos e Valores Mobiliarios
Chase Manhattan Securities (C.I.) Ltd.
Couingwood Limited
Delmarva Sand & Gravel Company
Fabrica Nacional de Sacos, S.A.
First Victoria Limited Partnership
GK Company
Global Trading International Corporation
H.A. Limited Partnership
Hanover Manor Associates
Harbour Bay Joint Venture
Jhetta Limited Partnership
Keri Limited Partnership
Northgate Limited Partnership
O & C Contractors, Inc.
Octogonal Empreendimentos Ltda.
P.T. Chase Leasing Indonesia
Polisac, S.A.
Sebastian Associates
Sebastian Lakes Associates
SPH Associates
Ten Thousand Three Hundred Fifty (10350) Wilshire Boulevard, Inc.

The Woodlands Commercial Center, Ltd.
Wilmington International Corporation

Manufacturers Hanover Corporation:

Subsidiaries and Affiliates:

Manufacturers Hanover Leasing S.p.A.
Manufacturers Hanover Asia Limited
Manufacturers Hanover U.K. Holdings Limited
Manufacturers Hanover Cellular Services Ltd.
Manufacturers Hanover Leasing S.p.A.
Manufacturers Hanover Central Leasing Corporation
Anglo-Yugoslav Bank Limited
Manufacturers Hanover Leasing Corporation Y Compania Limitada
Arrendadora Bancomer, S.A. de C.V.
Manufacturers Hanover de Arrendamiento Financiero S.A.
Korea Industrial Leasing Co., Ltd.
Manufacturers Hanover Central Leasing Corporation
MH World Trade Corporation Mexico

Chemical New York Corporation:

Subsidiaries and Affiliates:

Chemical Bank of Canada
Chemco Canada Leasing, Inc.
Chemical Community Development, Inc.
Chemical International Bank
Chemical International Finance, Ltd.
Chemco International Leasing Inc.
Chemical Videotex Services, Inc.
Chemgraphics Systems, Inc.
ChemLease Worldwide, Inc.
ChemNetwork Processing Services, Inc.
Chem Credit, Inc.
Chemco International, Inc.

Security Pacific Corporation:

Subsidiaries and Affiliates:

Bussan SecPac, Ltd.
Caixa Leasing S.A.
China International Finance Ltd.
Gwynvett European Securities, Ltd.
Hoare Candover Ltd.
Hoare Govatt (Channel Islands) Ltd.
— Hoare Govett Services (Guernsey) Ltd.
— Hoare Govett Services (Jersey) Ltd.
— Tremac Nominees (Guernsey) Ltd.
— Tremac Nominees (Jersey) Ltd.
Hoare Govett Summit Securities (Ptc) Ltd.
Hoare Octogon Ltd.
Hong Kong & Shanghai Insurance Co. Ltd.
McIntosh Securities Ltd.
NDC Securities Ltd.
SPAL Management Ltd.
— International Consultants Ltd.
— SPA Nominees, Ltd.
— SPI Limited
— SPAL Management (Private) Ltd.
— SPAL Management (Retail) Ltd.
Security Pacific (U.K.) Corp.
Security Pacific Bank S.A.
Security Pacific Capital Australia Ltd.
— Security Pacific Finance, Ltd.
— Security Pacific Industrial, Ltd.
— Security Pacific Securities, Ltd.
Security Pacific Leasing, S.A.
Security Pacific Private Capital Asia Ltd.
Sumitrust Security Pacific Investment Managers, Inc.

APPENDIX B

Before the
BOARD OF GOVERNORS OF
THE FEDERAL RESERVE SYSTEM
Washington, D.C. 20551

IN THE MATTERS OF

Docket No. 85-12042

APPLICATION OF CITICORP FOR APPROVAL TO UNDERWRITE AND DEAL IN CERTAIN SECURITIES TO A LIMITED EXTENT

Docket No. 85-23992

APPLICATION OF J.P. MORGAN & CO., INC., FOR APPROVAL TO UNDERWRITE AND DEAL IN CERTAIN SECURITIES TO A LIMITED EXTENT

COMMENTS OF THE UNITED STATES
DEPARTMENT OF JUSTICE

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* * * *

III. THE APPLICATIONS OF CITICORP AND MORGAN ARE CONSISTENT WITH SECTION 20 OF THE GLASS-STEAGALL ACT

A. The Glass-Steagall Act Permits a Bank Affiliate to Underwrite and Deal in Bank-Ineligible Securities Provided that the Affiliate Is Not "Engaged Principally" in Such Underwriting and Dealing.

The Glass-Steagall Act, which governs the relationship between investment and commercial banking, clearly differentiates between banks and their affiliates with respect to the limitation it imposes on their securities activities.

Sections 16 and 21 of Glass-Steagall contain absolute prohibitions against banks directly engaging in all but a few enumerated securities activities.[17] Section 16 provides that national banks and state member banks "shall not underwrite any issue of securities or stock . . ." [18] Similarly, Section 21 states that any firm "*engaged* in the business of issuing, underwriting, selling or distributing [stock] or other securities" shall not "engage at the same time to any extent whatever in the business of receiving deposits." [19] The precise and full prohibitions of Sections 16 and 21 have been interpreted to bar conduct by banks falling within their terms. Thus, in *Securities Industry Ass'n v. Board of Governors*, 104 S. Ct. 2979 (1984), the Supreme Court held that, since commercial paper is a security, a bank could not underwrite commercial paper under the "flat prohibitions" of Sections 16 and 21. *Id.* at 2985.

In contrast, the Glass-Steagall Act does not impose a blanket prohibition on the securities activities of bank affiliates.[20] "[A] bank affiliate may engage in activities that would be impermissible for the bank itself," [21] subject to the limitation found in Section 20 of Glass-Steagall. Section 20 provides in pertinent part:

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[17] Member banks may purchase and sell stock and other securities upon the order and for the account of others. 12 U.S.C. § 24 (Seventh). In addition, member banks are authorized to purchase for their own account certain marketable debt obligations, referred to as "investment securities," pursuant to regulations issued by the Comptroller of the Currency. They are also permitted to underwrite and freely deal in general obligation government securities.

[18] 12 U.S.C. § 24 (Seventh).

[19] 12 U.S.C. § 378 (emphasis added).

[20] Bank holding companies are within the definition of "affiliate" and thus within the permissive ambit of Section 20. 12 U.S.C. § 221a(b)(4).

[21] Board of Governors v. Investment Company Institute, 450 U.S. 46, 64 (1981).

> [N]o [national bank] shall be affiliated . . . with any corporation, association, business trust or other similar organization *engaged principally* in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes or other securities.[22]

Thus, as the Supreme Court has stated, while Glass-Steagall "entirely prohibits the same firm from engaging in banking and in the underwriting business, . . . § 20 does not prohibit bank affiliation with a securities firm unless that firm is 'engaged principally' in activities such as underwriting." [23]

* * * *

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[22] 12 U.S.C. § 377 (emphasis added).

[23] Board of Governors v. Investment Company Institute, 450 U.S. at 64.

The Securities Industry Association ("SIA") and Investment Company Institute ("ICI") have argued that Section 20 of Glass-Steagall should be read literally to prohibit a bank's affiliate from being "engaged principally" in the underwriting of any securities, be they eligible or ineligible. Under their contention, a bank affiliate could not limit its activities to underwriting eligible securities, even though such activity would be permitted to the bank itself. SIA Comments Regarding Citicorp Application at 6-9; ICI Comments Regarding Citicorp Application at 12.

This argument, however, is totally at odds with the obvious purpose of the Glass-Steagall Act as well as the Supreme Court's decision in Board of Governors v. Investment Company Institute. According to SIA and ICI, Congress passed Glass-Steagall to force bank holding companies to move securities activities in eligible securities from bank affiliates to the banks. This contention, stands the statutory scheme on its head. There is no question that Congress felt the bank safety and conflicts of interest risks created by allowing banks to engage in securities activities were greater than the risks created by allowing such activities in bank affiliates. Consequently, as the Supreme Court stated in Board of Governors v. Investment Company Institute, the Glass-Steagall Act provides that "a bank affiliate may engage in activities that would be impermissible for the bank itself," rather than vice versa. See Note 21, *supra*.

APPENDIX C

COMPTROLLER OF THE CURRENCY
ADMINISTRATOR OF NATIONAL BANKS

Washington, D.C. 20219

January 30, 1987

Mr. William W. Wiles, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Hearing before the Board of Governors of the Federal Reserve System ("Board") on the Applications of Citicorp, J. P. Morgan & Co., Incorporated, and Bankers Trust New York Corporation to underwrite and deal in commercial paper, mortgage-related securities, municipal revenue bonds and consumer-receivable related securities pursuant to the Bank Holding Company Act of 1956, as amended

Dear Mr. Wiles:

The Office of the Comptroller of the Currency ("Office") has reviewed the Board's December 31, 1986 Order for Hearing Before the Board ("Order for Hearing"), convening a February 3, 1987 hearing on the above-referenced Applications. The applicants have requested Board approval under Section 4(c)(8) of the Bank Holding Company Act, 12 U.S.C. § 1843(c)(8), and Section 225.21(a) of the Board's Regulation Y, 12 C.F.R. § 225.21(a), to engage in "underwriting" and "dealing in" the above-listed instruments through wholly-owned nonbanking subsidiaries. The Board has stated that because each of the proposed underwriting subsidiaries is affiliated through common ownership with a member bank within the meaning of 12 U.S.C. § 221a(b), the Board must determine whether those subsidiaries would

be "engaged principally" in the "issue, flotation, underwriting, public sale, or distribution" of securities within the meaning of Section 20 of the Glass-Steagall Act ("Act"), 12 U.S.C. § 377.

The Office's interest in this matter arises from its status as the primary regulator of national banks and the primary administrator of the National Bank Act, 12 U.S.C. § 1 *et seq.* While the administration of the Bank Holding Company Act and of holding company affiliations pursuant to Section 20 of the Glass-Steagall Act are not a routine aspect of the Comptroller's regulatory or supervisory programs, the Order for Hearing is of interest to us due to the impact of affiliate activities on national bank operations.

* * * *

We wish to address briefly the Board's question concerning whether the Section 20 term "securities" should be interpreted to include all securities, including both "eligible" and "ineligible" securities, as well as its concerns over the possible manipulation of a particular standard (such as volume). As the Board is aware, Section 16 of the Act authorizes national and member banks to engage directly in certain types of securities activities. By the same token, Sections 20 and 32 of the Act permit bank affiliates to engage in activities which a bank itself cannot conduct. *See Board of Governors of the Federal Reserve System* v. *Investment Company Institute*, 450 U.S. 46, 60 (1981) (*"ICI"*). As the Board is also aware, however, the sections of the Banking Act of 1933 which are commonly referred to as the Glass-Steagall Act are generally designed to accomplish the same general purpose, i.e., to preclude commercial banks and their affiliates from engaging in certain types of investment banking activities. Thus, the provisions of the Glass-Steagall Act should be read collectively, in order to ensure a harmonious construction of the Act consistent with its overall legislative purposes. Indeed, as a matter of pure

statutory interpretation, one part of a statute cannot be read in isolation from other parts of the same or related statute. *See, e.g., Securities Industry Association* v. *Board of Governors of the Federal Reserve System,* 468 U.S. 207, 216-21 (1984).

Applying these principles, it is our view that the only proper measure of whether a bank affiliate has crossed Section 20's "principally engaged" threshold is whether that affiliate is engaged in an impermissible level of securities activities which are covered by Section 20. These covered activities, in our view, do not include any activities which a bank may conduct under Section 16 of the Act. A contrary interpretation would lead to the result that a member bank could not be affiliated with a company which engages exclusively in activities which the bank itself could conduct; if the "principally engaged" standard includes bank-eligible securities activities, member banks directly would be able to conduct authorized activities (e.g., underwritings of government and municipal securities) but would not be able to conduct the same activities through an affiliate. This result would be totally at odds with the purposes of the Act and relevant judicial interpretations. *ICI, supra,* 450 U.S. at 60. The Court of Appeals for the D.C. Circuit, in fact, recently has affirmed that the provisions of the Act must be read harmoniously, and in order to avoid one section rendering another section "entirely nugatory." *SIA, supra,* Slip Op., at 10.

We note that the regulations and administrative interpretations of the Board reflect an understanding that securities activities which member banks may conduct directly under Section 16 of the Glass-Steagall Act should not be included in the measurement of "principally engaged" for Section 20 purposes. Similarly, this analysis is consistent with the Board's interpretations under Regulation R, 12 C.F.R. Part 218, which have consistently exempted from Section 32's prohibition (and from its

"primarily engaged" test) the activities of bank affiliates which are authorized to banks under Section 16 of the Act. In those instances where the Office has had occasion to interpret the provisions of Section 20 and 32, it similarly has relied on this analysis. *See, Decision of the Comptroller of the Currency on the Application to Charter J. & W. Seligman Trust Company, N.A., reprinted in* [1982-83 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,463 (Feb. 2, 1983); *Decision of the Comptroller of the Currency to Charter Dreyfus National Bank and Trust Company, reprinted in* [1982-83 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,464 (Feb. 7, 1983).

*   *   *   *

Sincerely yours,

/s/ Dean S. Marriott
DEAN S. MARRIOTT
Senior Deputy Comptroller for Bank Supervision

No. 87-1513

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

SECURITIES INDUSTRY ASSOCIATION,

Petitioner,

—v.—

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM, *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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Attorneys for Petitioner Securities Industry Association

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

No. 87-1513

SECURITIES INDUSTRY ASSOCIATION,

Petitioner,

—v.—

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

Respondents' briefs in opposition confirm that a writ of certiorari should issue in this case.

1. Respondents do not dispute the overriding national significance of the decision below. Nor could they do so, given the demonstrable impact of the decision on the long-standing structure of the nation's financial services industry. *See* SIA Pet. 11-15. Respondents instead attempt to confine the scope of this case solely to underwriting government securities (Fed. Opp. 7-8), but its reach is far broader. By misreading Section 20 of the Glass-Steagall Act to exclude government securities, and misconstruing that section's "engaged principally" restriction, the decision below authorizes bank affiliates to rank among the na-

tion's major underwriters of *other* securities as well. *See* SIA Pet. 20, 23-24. As the Board majority itself emphasized, this case involves "the first major entry of banking organizations into the field of underwriting and dealing in *ineligible* securities." 134a (emphasis supplied).

It is simply preposterous, we submit, to conclude that the Congress which enacted the Section 20 *prohibition* in order to "put[ ] an end" to bank securities affiliates[1] imagined the section would be a *permission* for banks to affiliate with ineligible securities operations as large as those of PaineWebber or to absorb securities entities as extensive as Merrill Lynch. Yet, as respondents in effect concede, that would be the result of Glass-Steagall if the decision below were permitted to stand. *See* SIA Pet. 14-15.

2. Respondents claim this patently illogical result is required, because they "cannot imagine" any reason why the Glass-Steagall Congress would have restricted bank affiliates from engaging in activities expressly permitted to banks themselves. Fed. Opp. 9. In fact, Congress had every remedial reason to do so with respect to dealing in government securities. By the 1930s, affiliates originally established by banks merely as government securities dealers (*see* SIA Pet. 20; 31a) had expanded their operations so far into bank-prohibited securities activities that they became known as the "back door in banking."[2] Congress was keenly aware of that evolution. Asked specifically during the Senate debates whether bank securities affiliates could continue if they dealt *only* in government securities, Senator Glass answered, "I am objecting to affiliates *altogether*," explaining further that he objected to "back-door arrangement[s]" through which banks engaged in unauthorized businesses and wanted to "make it impossible" for that to recur. 76 Cong. Rec. 2000 (1933) (emphasis supplied); *see* 28a.

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1 77 Cong. Rec. 3917 (1933) (remarks of Rep. Luce, one of the House managers of the Glass-Steagall bill).

2 W. Peach, *The Security Affiliates of National Banks* 177 (reprinted ed. 1975).

Section 20 by its terms thus severely restricted bank affiliates from underwriting any "securities," government or otherwise, thereby ensuring that bank affiliates could not use a base of government securities business again to push open the "back door in banking"—or, as Chairman Volcker aptly put it in dissent here, "to bootstrap securities activities that Congress clearly wished to restrain or prohibit." 137a n.2. The decision below, by interpreting Section 20 to permit just the sort of "bootstrap[ping]" Congress meant to prohibit, turns the congressional mandate on its head.

3. To rationalize this statutory reversal, respondents must resort to rearguing that the term "securities" in Glass-Steagall is ambiguous—an argument the Court repeatedly has rejected. *See* SIA Pet. 17-18. Respondents cite "differen[ces]" among sections of the Act as supposedly creating ambiguity concerning government securities. Fed. Opp. 9. These differences actually demonstrate its absence. In Section 16 Congress prohibited banks from underwriting any "securities," but expressly exempted government securities from that proscription. Again, Congress amended the underwriting prohibition of Section 21 in 1935 specifically to incorporate the Section 16 exemption for government securities, showing, as one court has put it, that "Congress knew how to indicate that a section of the Act was intended as a specific exception to another section."[3] By contrast, Congress has not—either initially or by any amendment—"indicat[ed]" the term "securities" in Section 20 is to be qualified in any way. The contrary conclusion below conflicts directly with this Court's instruction that the prohibitory terms of the Act are to be applied "as they were written." *ICI* I, 401 U.S. at 639; *see SIA* I, 468 U.S. at 149-52.

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3 *Investment Co. Inst.* v. *FDIC*, 815 F.2d 1540, 1547 (D.C. Cir.), *cert. denied*, 108 S. Ct. 143 (1987).

As the Senate Report explained, the amendment to Section 21 in 1935 was "necessary" to make clear that nonmember banks, which were not covered by the Section 16 exemption but were within the Section 21 prohibition, could underwrite government securities. S. Rep. No. 1260, 73d Cong., 2d Sess. 2 (1934). Contrary to respondents' speculation (Fed. Opp. 9 n.6), it had nothing to do with Section 21 being a criminal provision.

4. Respondents all but concede that the Board for over 50 years has read the term "securities," as used in Section 32 of the Act, to *include* government securities. *See* SIA Pet. 21-23. Respondents incorrectly suggest this interpretation can be brushed aside as a regulatory relic. Fed. Opp. 11 n.9. Not only is the Board's own contemporaneous understanding of the Glass-Steagall Act—a statute the Board helped draft and amend—especially important,[4] but the Board has also reiterated the same view, without modification, throughout more than five decades, up to and including today. *See* Regulation R, 12 C.F.R. § 218.2 (1988).

Only four years ago, the Court in *SIA* II held the Board's interpretation of terms in Section 32 equally applicable to the parallel terms in Section 20 (*see* SIA Pet. 22), having heard the Board urge just that.[5] Yet, the Board majority here interpreted the term "securities" in Section 20 exactly opposite to the Board's interpretation set forth in the *same* Section 32 regulation relied upon in *SIA* II. More than a matter of administrative arbitrariness, which certainly it is (15a-17a), the majority's ruling raises important questions concerning administrative disregard of representations made to, and instructions received from, the Court. Again, review is warranted.[6]

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4 *E.g.*, *Zuber* v. *Allen*, 396 U.S. 168, 192 (1969).

5 In *SIA* II, the Board represented that its "longstanding and virtually contemporaneous" Regulation R under Section 32 "applies with equal force" to Section 20, "a closely related provision of the same Act." Brief for the Federal Respondents at 35-37, *SIA* II, 468 U.S. 207 (1984) (No. 83-614).

6 The Board suggests (Fed. Opp. 11 n.9) that it has not "treated" government securities operations as subject to the restrictions of Section 32 but omits to say that such "treat[ment]" has been an exercise of its express *exemptive* authority under Section 32—authority the Board admittedly lacks under Section 20—and not an expression of the Board's view of a matter to which Section 32 "by its terms . . . does not apply." 12 C.F.R. § 218.2 & n.1. *See* SIA Pet. 22-23; 16a-17a.

Respondents also refer to recent rulings in which the Board permitted bank holding company subsidiaries to carry on government securities activities. Fed. Opp. 11; Bank Opp. 4. But those rulings reflected

5. Respondents cite current legislative deliberations in an effort to avoid further review, even asserting the Court's exercise of its jurisdiction to construe the law would somehow "interfere" with congressional debate. Fed. Opp. 13; *see* Bank Opp. 10. To the contrary, not only is ultimate congressional action uncertain,[7] but the Court's teaching as to proper construction of the Act surely would be of aid to the legislative process. As Representative Markey, Chairman of a subcommittee now considering Glass-Steagall issues, recently stated concerning this case:

> I would urge the Court not to decline review on the basis of a legislative contingency. I have been forthright in my statements that it is time that Congress address the pressing issues raised by the Glass-Steagall debate. I do not, however, think that the Court should concede its own important interpretive role in the event that Congress does not have the opportunity to resolve these issues this year.[8]

CONCLUSION

Absent review, the decision below will shatter the structure Congress designed for the financial services industry over the last half century. The government regulators, the banking in-

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only the Board's policy determination under the Bank Holding Company Act; the rulings did not even mention, much less determine, *any* issue under the Glass-Steagall Act.

7 *See* SIA Pet. 16 n.23 (noting that in 1984 the Senate, but not the House, had passed legislation similar to that now pending).

8 134 Cong. Rec. E 1591 (daily ed. May 18, 1988). With specific reference to the expiration of the congressional moratorium of the effective date of the Board's ruling, Representative Rinaldo, the ranking Republican on the same subcommittee, stated, "I would hope that the Court would not read anything into [that expiration]"; it "indicates nothing more than that the legislative efforts to modify or repeal Glass-Steagall have provoked enormous debate." 134 Cong. Rec. E 1636-37 (daily ed. May 19, 1988). *See also* 134 Cong. Rec. E 1473 (daily ed. May 10, 1988) (Remarks of Rep. Morrison).

dustry and the securities industry are all before the Court. A writ of certiorari should issue to review the decision below.

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